

I. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Overview: an expansion facing headwinds

The global expansion has slowed as the effects of the sharp increases in oil prices have set in. The deceleration has been particularly marked in Japan and, outside the OECD, in China. It has been less pronounced but still tangible in the United States. In Europe, higher energy prices and weak confidence in some countries are reining in a recovery that had strengthened beyond expectations early in the year. In most OECD countries, headline inflation has been pushed up, but core inflation and wage demands have remained subdued – a tribute to the credibility built up by central banks since the oil shocks of the 1970s. Provided oil prices do not rise further, the global expansion should regain momentum in the course of 2005, following a period of milder growth, and much of the residual economic slack should be worked off by late 2006 (Table I.1). If as assumed second-round effects are contained, headline inflation should ease back. Unemployment should resume its decline once the bulk of the oil shock is absorbed, but would on average remain above its structural level.

High oil prices have slowed but not derailed the global expansion

Over the near term, the risks surrounding this projection are dominated by oil price uncertainty. While there is some evidence that oil prices have overshot, they could stay high or even rise. If so, their detrimental impact on activity, inflation

Uncertainties and tensions have increased

Table I.1. The expansion continues

<i>OECD area, unless noted otherwise</i>									
Average							2004	2005	2006
1992-2001	2002	2003	2004	2005	2006	q4	q4	q4	
Per cent									
Real GDP growth^a	2.7	1.6	2.2	3.6	2.9	3.1	3.1	3.1	3.1
United States	3.4	1.9	3.0	4.4	3.3	3.6	3.8	3.3	3.6
Japan	1.2	-0.3	2.5	4.0	2.1	2.3	2.6	2.4	2.1
Euro area	2.0	0.9	0.6	1.8	1.9	2.5	1.9	2.3	2.5
Output gap^b	-0.8	-1.4	-1.7	-0.8	-0.6	-0.2			
Unemployment rate^c	6.8	6.7	6.9	6.6	6.5	6.3	6.5	6.4	6.2
Inflation^d	3.9	2.6	2.0	1.8	1.7	1.7	1.9	1.7	1.7
Fiscal balance^e	-2.5	-3.2	-3.7	-3.5	-3.2	-3.2			

a) Year-on-year increase; last three columns show the increase over a year earlier.

b) Per cent of potential GDP.

c) Per cent of labour force.

d) GDP deflator. Year-on-year increase; last three columns show the increase over a year earlier.

e) Per cent of GDP.

Source: OECD Economic Outlook 76 database.

and unemployment might exceed what is suggested by standard model-based simulations. Fiscal and external imbalances continue to be sources of potential tension. They need not lead to any disruptions in the near term but could push up long-term interest rates and will in any event require adjustments if they are to unwind benignly over the longer run. One specific risk relates to the possibility of a large fall in house prices, and hence lower consumption, where they are too richly valued, though the fact that housing prices have started to weaken in some countries can be seen as a natural counterpart to the resilience of the housing market as monetary policy eased in response to the downturn. On the bright side, however, and provided oil prices evolve favourably, strengthened business balance sheets and profits make it possible that corporate fixed investment would exceed expectations, following several lean years.

Monetary stimulus can be withdrawn gradually...

The impulse to growth from monetary stimulus is fading as policies in most OECD countries start reverting to a more neutral stance. The first-round price increases stemming from the oil shock did not call for interest rate hikes and indeed central banks have not invoked them to tighten their policy stance. However, over the next two years, shrinking economic slack and exceptionally cheap money will require a progressive withdrawal of central bank stimulus, albeit conditional on how swiftly the oil shock's adverse impact on activity is overcome. Accordingly, the US and UK monetary authorities, as well as those in several smaller economies, have already started to raise rates. Their counterparts in the euro area and Japan – who for the moment still have reasons to wait and see – are expected to follow suit with a substantial lag.

... but fiscal consolidation should not be put off

On the fiscal side, as noted above, the urgency to act is more general: in many OECD countries, deficits are large and persistent, whilst debt ratios are rising. With the pressures exerted by ageing populations either starting to be felt or approaching rapidly, the consolidation of public finances ought to be stepped up.

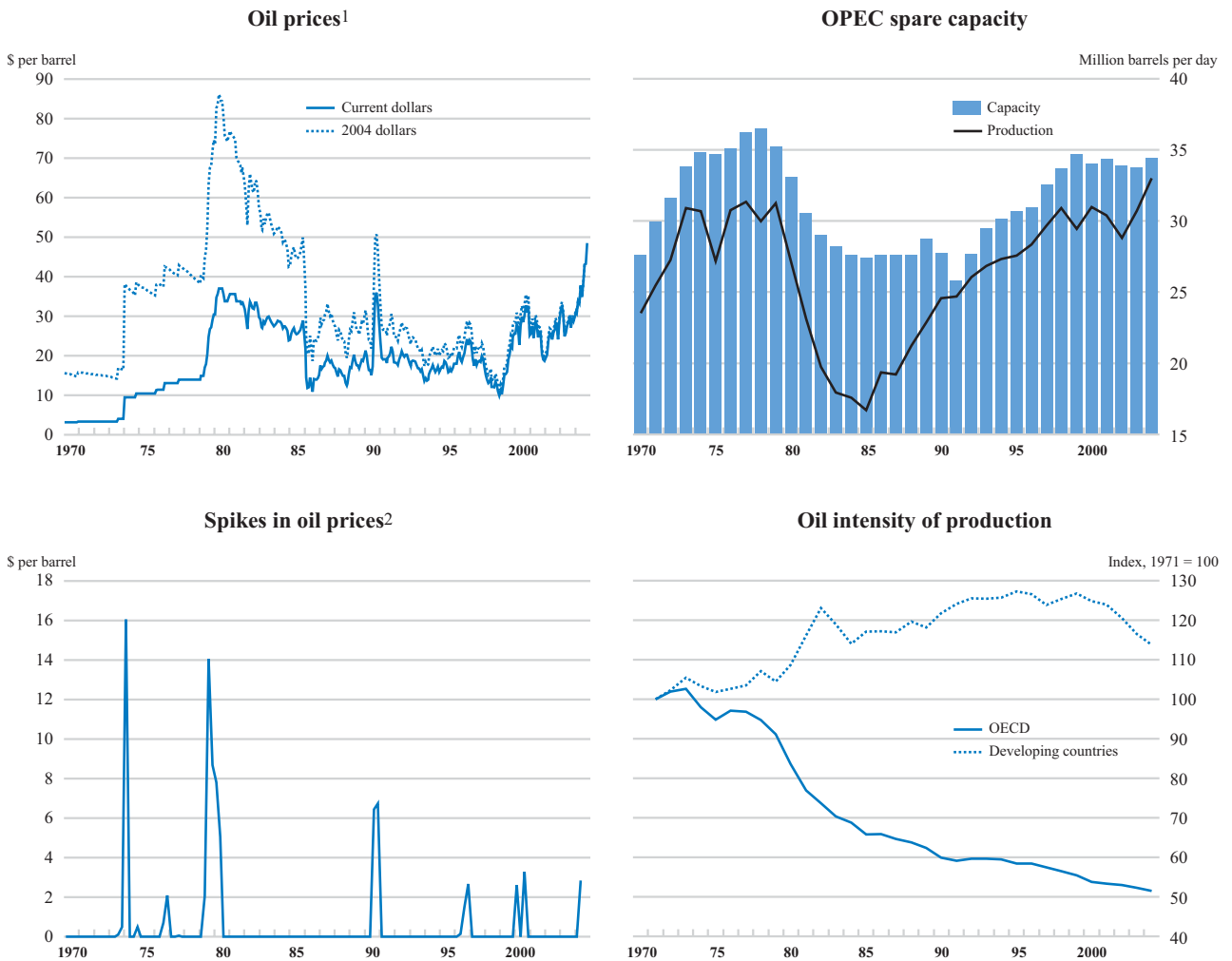
Higher oil prices exert a drag on the global expansion

Oil prices have risen substantially...

Crude oil prices have risen rapidly, from around \$32 for Brent at the time of the previous *OECD Economic Outlook* to \$50 in mid-October, although they eased back to around \$42 in mid-November.¹ Measured in constant prices, the increase has been more limited than the oil shocks of the 1970s (Figure I.1). Moreover, OECD countries' dependence on oil, measured by the quantity of oil used per unit of real GDP, has almost halved since the 1970s, so the real income and terms-of-trade effects for most of them are smaller. At the same time, the easing of long-term interest rates indicates that inflation expectations are more firmly anchored than in the past, as the oil shock occurs in a context of low and stable core inflation. Nevertheless, higher oil prices and the associated uncertainty are contributing to the deceleration of activity observed in United States, Japan and a number of other countries in the course of 2004, and are impeding the euro area recovery (Figure I.2).

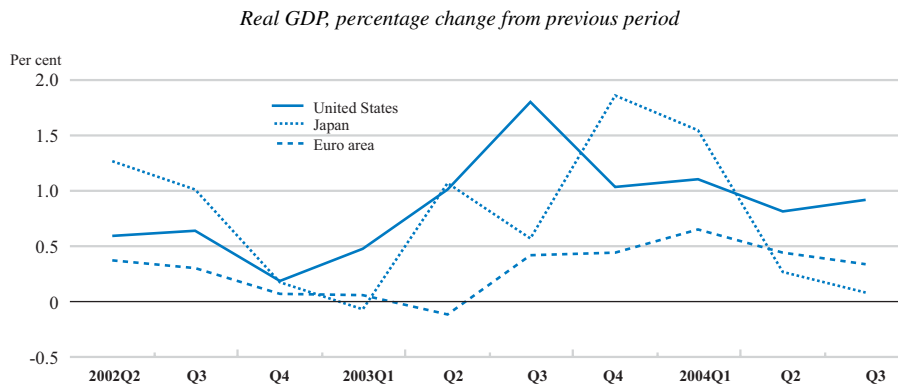
1. Over the past year, the price of West Texas Intermediate crude on average exceeded the price of Brent by some \$2½. During the past two years, oil prices have consistently exceeded the upper bound of the \$22-28 band set as a target by the Organisation of Petroleum Exporting Countries (OPEC) in 2000.

Figure I.1. Oil prices have soared



1. Brent crude oil from May 1987 on. Earlier data are OECD estimates for crude oil of the same quality as Brent. In real terms, deflated by US consumer price index.
 2. Difference between latest quarterly average spot price of Brent crude and highest quarterly average over the preceding three years, in real terms.
 Source: OECD Economic Outlook 76 database and International Energy Agency.

Figure I.2. The expansion has lost some momentum



Source: OECD Economic Outlook 76 database.

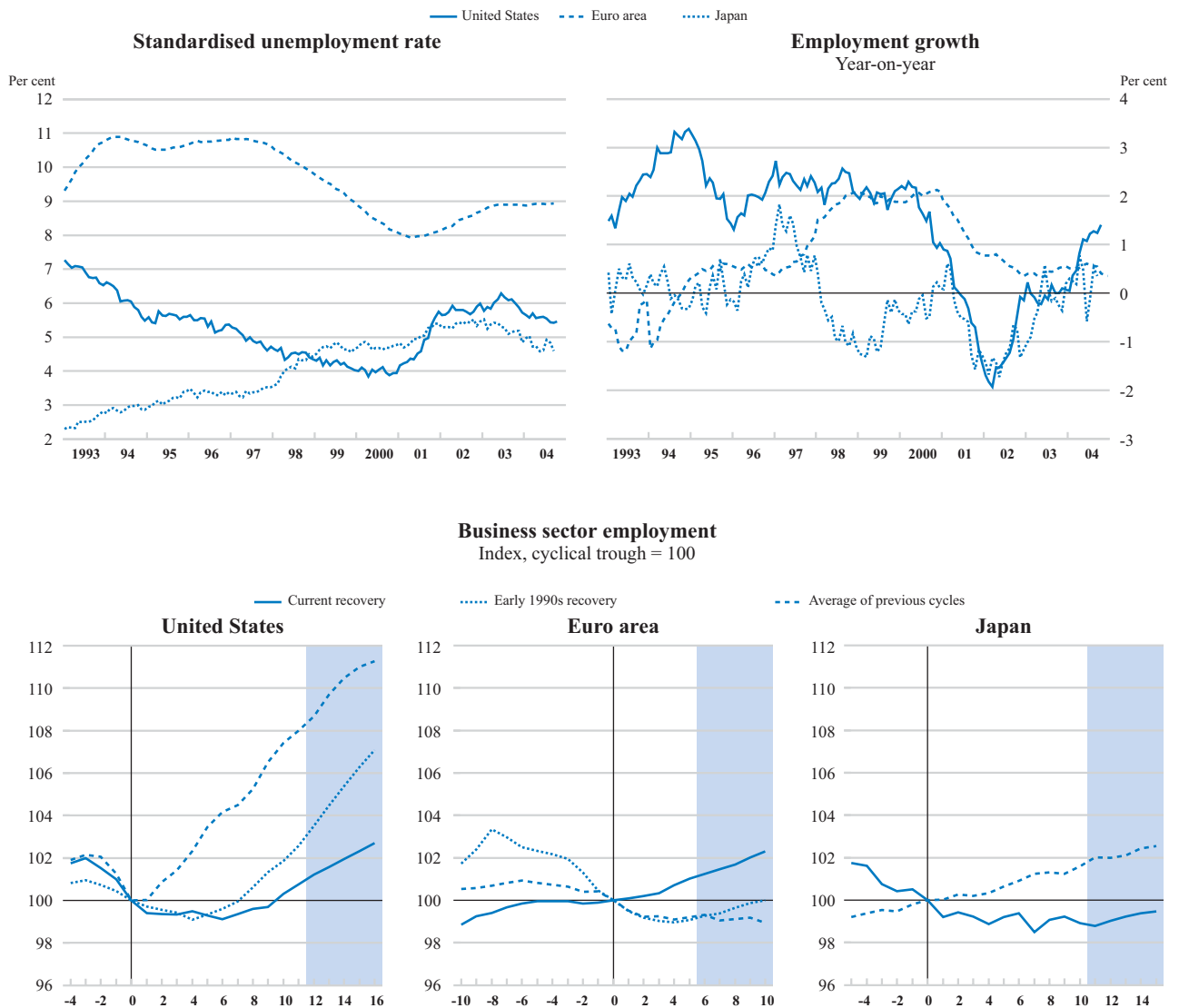
... with growth slowing somewhat in the United States...

In the United States, growth fell back to around its potential rate in the second quarter but regained momentum in the third. Fixed business investment was buoyant, but household consumption of non-durables was dented by soaring energy prices. The US recovery has eventually become more job-intensive (Figure I.3), but it remains historically lean in that respect. The unemployment rate, which by October 2004 stood at 5½ per cent of the labour force, is lower than at the same stage of previous cycles but still distinctly above its structural level and the participation rate has declined.

... and held back in the euro area...

In the euro area, growth surprised on the upside in the first quarter of 2004 but subsequently slowed, whilst unused capacity remains distinctly higher than across the Atlantic. Growth has been pulled mainly by external demand. Household

Figure I.3. Labour markets perform unevenly



Note: A cyclical trough is usually defined as a trough in the level of real GDP. For the United States the NBER chronology is used. The average of previous cycles includes major cycles from the 1960s to the 1980s (late 1970s to 1990s for Japan). The last cyclical trough is 2001Q4 for the United States, 2002Q1 for Japan and 2003Q2 for the euro area. The shaded area shows the projection period for the current cycle.

Source: OECD Economic Outlook 76 database.

consumption has remained lacklustre, reflecting mediocre employment and income growth, with unemployment having drifted up to close to 9 per cent of the labour force. Thus far, business investment has also failed to take off in earnest, despite a brief spurt in late 2003. In sum, the recovery has not yet become self-sustained.

Within the euro area, some countries have tended to show more domestic strength than others, and some have benefited more than others from the buoyancy of foreign demand.² Among the larger countries, France and Spain have stood out in 2004 with final domestic demand contributing most to real GDP growth, whereas in Germany it has been very weak (Figure I.4). There, the recovery was almost exclusively pulled by exports. In Italy, the persistent deterioration in export performance has been a drag on the recovery. In the smaller euro area countries – although not in the Netherlands – domestic demand growth has been fairly robust.

... where, however, developments diverge

Elsewhere in Europe and North America, growth has remained vigorous or picked up despite higher energy prices. This is the case in many smaller OECD economies, including in the new members of the European Union and in Turkey. OECD (Mexico and Norway) and non-OECD net energy exporters have received a boost from rising oil and gas prices. In the United Kingdom, however, activity has recently slowed, albeit following a remarkably resilient performance in the course of the global downturn.

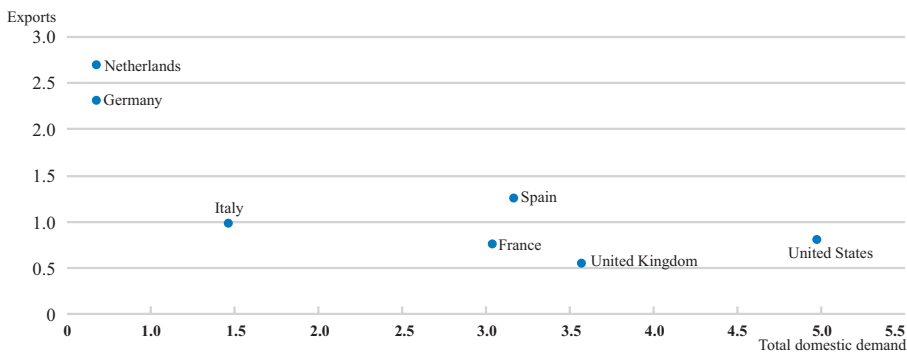
In many other countries, growth has firmed up

In Japan, growth has weakened, following a couple of very strong quarters around the turn of the year.³ The deceleration was led by business fixed investment, which in the third quarter was held back by an unusually high number of typhoons. Exports also lost some of their momentum, partly reflecting a slowdown in Chinese demand. Consumption, however, held up well, supported by incipient job creation, even if most of the new hires have thus far been in the form of non-permanent contracts, which has contributed to putting downward pressure on average worker compensation and thereby on aggregate household income.

In Japan, activity has decelerated markedly,...

— Figure I.4. Recovery in Germany and Italy has relied more on exports —

Contributions to growth of real total aggregate demand in 2004, percentage points



Note: Contributions are calculated in terms of total aggregate demand defined as total domestic demand plus exports.

Source: OECD Economic Outlook 76 database.

2. For further analysis of the underlying factors, see Hoeller, P., C. Giorno and C. de la Maisonneuve, "One money, one cycle? Making monetary union a smoother ride", *OECD Economics Department Working Papers*, No. 401, 2004.
3. The Japanese national accounts are to undergo a comprehensive revision in December 2004, with a switch to chain-linking. This will substantially affect the profile of real GDP (and of the GDP deflator) going back all the way to 1994.

... paralleling a slowdown in China

Meanwhile, in non-OECD Asia activity slowed markedly. In China, following monetary and administrative measures to address overheating symptoms and reflecting the adverse impact of higher oil prices,⁴ credit growth slowed and investment decelerated. Growth in Latin America gathered speed, however, on the back of maintained robust export performance and helped by terms-of-trade gains.

Core inflation remains subdued in the United States...

So far, core inflation has generally remained rather subdued, even though energy price increases have pushed up headline inflation (Figure I.5). This decoupling reflects both the extent of cyclical slack and continuing competition and productivity gains in internationally open sectors. The very limited size of the second-round effects observed to date is also a result of greater central bank credibility than in past cycles. In the United States, the buffer provided by a combination of healthy profit margins and spare capacity has helped limit the pass-through of rising energy and commodity prices into core consumer prices. Wage inflation has been moderate, although non-wage labour costs – especially on account of health benefits – have continued to outpace wages. Inflation expectations appear much better anchored than in previous episodes.

... and did not increase significantly in the euro area

In the euro area, inflation expectations have remained low and well-anchored, with various core inflation measures hovering somewhat below the 2 per cent mark. This benign response to the inflationary consequences of an oil shock stands in stark contrast with the rigidity and persistence displayed in the past by euro area inflation, which failed to decline as the output gap was widening.⁵ A number of temporary factors contributed to this persistence in the recent past, including higher-than-expected energy and unprocessed food prices as well as rises in indirect taxes (in particular on tobacco) and administered prices (notably in the health care sector). The stubbornness of inflation was also due to the fact that while labour costs decelerated, so did labour productivity, so that notwithstanding far greater slack, unit labour costs rose more rapidly than in the United States. However, more fundamentally, the extent of slack present in the euro area economy was probably more limited than estimated earlier, implying less downward pressure on inflation. Indeed, the recent re-estimation of output gaps for OECD countries – which is reflected in this *OECD Economic Outlook* – suggests that this may well be the case for most euro area members.

In Japan, deflation persists

In Japan, deflation lingers on, even according to the headline consumer price measure, which directly incorporates the effect of higher energy prices, but most strikingly as measured by the GDP deflator (which, however, suffers from downward bias).⁶ As a result, nominal GDP has expanded by no more than 1½ per cent over the first ten quarters of the recovery and still stands about 4 per cent below its 1997 peak. In addition, land prices have continued to decline rapidly for the thirteenth year in a row. For inflation and inflation expectations to rise and durably stay positive, a sustained positive output gap may be required.⁷

4. The first-round impact of higher oil prices on Chinese real GDP growth is estimated to be far more severe than in past oil shock episodes and possibly as much as five times larger than in the OECD area as a whole, reflecting in particular China's much greater, and increasing, dependence on oil.

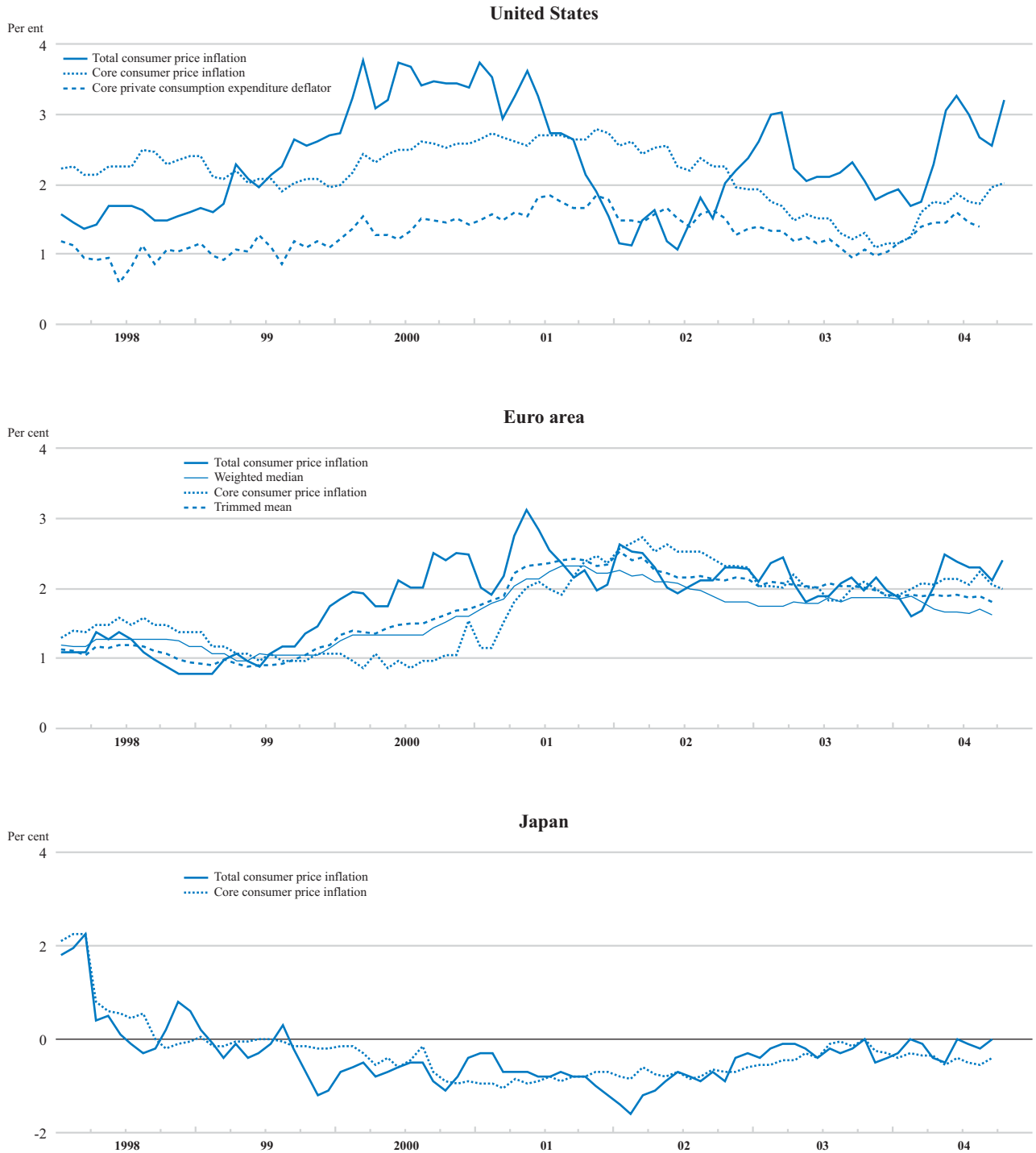
5. As a result, euro area inflation was typically underpredicted by Phillips-curve equations, as documented in *OECD Economic Outlook* No. 74, Table I.3.

6. The bias is partly due to the fact that the GDP deflator is a Paasche index based on fixed 1995 weights, in a context where the relative price of information technology goods falls rapidly, see Koga, M., "Why is the rate of decline in the GDP deflator so large?", Bank of Japan, *Economic Commentary*, No. 2003-02, 2003.

7. The flatness of the Phillips curve in Japan is documented by Mourougane, A. and H. Ibaragi, "Is there a change in the trade-off between output and inflation at low or stable inflation rates? Some evidence in the case of Japan", *OECD Economics Department Working Papers*, No. 379, 2004.

Figure I.5. Core inflation generally remains subdued

Year-on-year percentage change



Note: Harmonised index of consumer prices (HICP) for the euro area. Core is measured as total less food and energy. The weighted median and the trimmed mean inflation are both calculated from the monthly price changes of individual HICP components (at the 3-digit level). The weighted median price increase for each month is the value such that HICP components for a cumulative weight of 50 per cent have a higher or equal monthly increase and the remaining 50 per cent a lower or equal one. The bilateral 15 per cent trimmed mean is calculated by first taking the items that in each month have the highest and the lowest price changes, for a total 15 per cent (in weight terms) on each side, and assigning them a zero weight; then, after re-normalising the weights to sum to 1, a weighted mean is calculated from the remaining items. In each case, year-on-year inflation rates are obtained by compounding the aggregate monthly rates.

Source: OECD, *Main Economic Indicators*, US Bureau of Economic Analysis and Statistical Office of the European Communities (Eurostat).

Prospects to 2006: overcoming the oil shock

The expansion should regain momentum in 2005

The adverse effects of the oil price shock are currently working their way through. However, provided oil prices do not rise above their assumed path, the expansion should firm during 2005, with the OECD-wide output gap closing towards late 2006. At the same time, headline inflation should slow somewhat in the course of the projection period, as the first-round impact of the shock fades and on the presumption that second-round effects remain limited. Unemployment will stay relatively high and international imbalances are set to worsen.

Some of the near-term indicators suggest weakening momentum

Confidence indicators...

Partly reflecting the oil price shock and the related uncertainty, business confidence has softened in the United States since early 2004, albeit from high levels (Figure I.6). In the euro area at large and Japan, it has improved, although it does not much exceed long-run averages. Moreover, in the case of the euro area, more favourable perceptions of current conditions are accompanied by some scaling down of expectations regarding future prospects. Consumers are generally less upbeat than firms although their confidence slightly exceeds long-run averages in Japan. In the euro area, confidence has slowly strengthened but remains sub-par, especially in Germany, where household sentiment has barely improved in recent quarters.

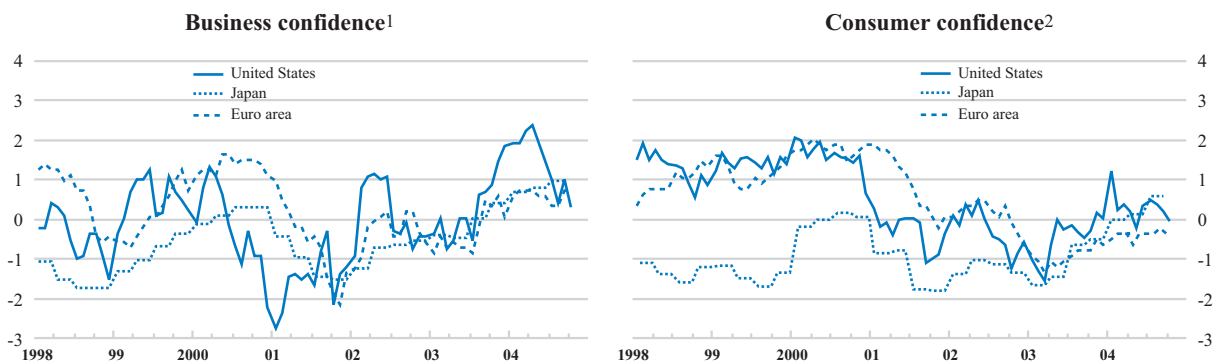
... order books...

Order books remain above average in the United States, despite a significant decline since April, led by weakening export orders. In contrast, strengthening export order books have underpinned a continued improvement in euro area orders in recent quarters, and these are now also above average.

... and indices of the high-tech cycle...

Growth in the high-tech sector seems to be peaking, at least as gauged by the semi-conductor billings for manufacturers headquartered in North America or by the so-called Tech-pulse index (Figure I.7). This is a factor underlying the deceleration

Figure I.6. Confidence is fragile



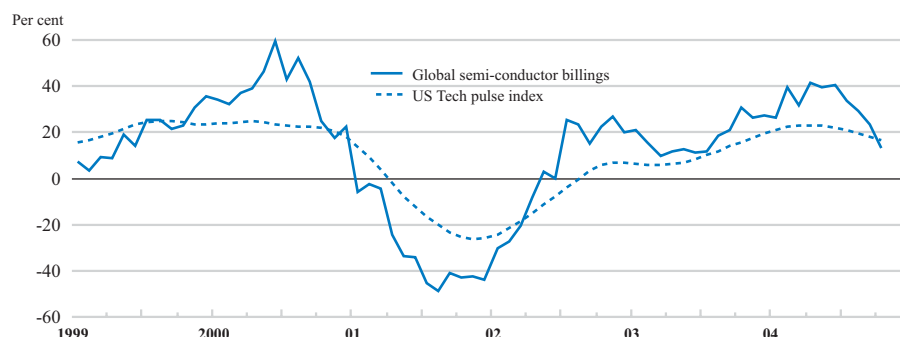
Note: All series have been normalised at the average for the period starting in 1985 and are presented in units of standard deviation. Monthly data, seasonally adjusted except Japan (quarterly, s.a.).

1. Business surveys for manufacturing: current production tendency for the United States, and future production tendency for Japan and the euro area.
2. Consumer confidence: composite indicators.

Source: OECD, *Main Economic Indicators*.

Figure I.7. High-tech sector activity is decelerating

12-month growth rate, in current dollar prices



Source: Federal Reserve Bank of New York and the Semiconductor Industry Association.

of trade in Asia. It is also visible in the slowdown of Finland's information-technology exports. Insofar as the fortunes of the high tech sector constitute a leading indicator of the overall cycle,⁸ this would be consistent with only limited closing of the output gap over the next few quarters.

The OECD's indicator-based models, which incorporate most of the information contained in the above leading indicators as well as that embodied in a number of other high-frequency data, suggest that over the near term, the recovery should remain at or revert to a pace close to potential in the larger OECD economies (Table I.2).

... point to continuing growth in the near term

Table I.2. Near-term estimates point to continued growth

Real GDP growth, per cent, quarter-on-quarter^a

	Outcomes			Estimates ^b	
	2004 Q1	2004 Q2	2004 Q3	2004Q4	2005Q1
United States	1.1	0.8	0.9	0.9 (± 0.4)	0.8 (± 0.6)
Japan	1.6	0.3	0.1	0.7 (± 0.5)	0.6 (± 0.7)
Euro area	0.7	0.5	0.3	0.5 (± 0.3)	0.6 (± 0.4)
Germany	0.4	0.4	0.1	0.3 (± 0.5)	0.4 (± 0.6)
France	0.7	0.6	0.1	0.8 (± 0.4)	0.6 (± 0.5)
Italy	0.5	0.4	0.4	0.5 (± 0.4)	0.5 (± 0.4)
United Kingdom	0.7	0.9	0.4	0.6 (± 0.3)	0.8 (± 0.3)
6 largest OECD economies	1.0	0.6	0.5	0.7 (± 0.3)	0.7 (± 0.4)

a) Based on GDP releases and high-frequency indicators published by 19 November 2004. Seasonally and in some cases also working-day adjusted. Aggregation for the six largest OECD economies uses 2000 purchasing-power-parity weights.

b) These estimates are indicative of near-term GDP developments but do not necessarily coincide with the OECD projections. The one-standard-error range associated with the estimates is indicated in parentheses. Typically, OECD projections lie within that range.

Source: OECD Economic Outlook 76 database and OECD estimates.

8. Evidence supporting this hypothesis for the US economy is provided by Hobijn, B., K. Stiroh and A. Antoniadis, "Taking the pulse of the tech sector: a coincident index of high-tech activity", Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, Vol. 9, No. 10, 2003.

Growth and inflation differentials will narrow

Policy stimulus is set to fade

The forces behind the expansion are shifting. Overall, the macroeconomic policy stance, while still very accommodative, is becoming less so. Limited fiscal stimulus is being injected in 2004, and some tightening is in the pipeline for 2005 (Box I.1). Over the projection period, the monetary stance is set for some normalisation – the more so where output gaps are closing. Financial market forces partly work in the same direction, with equity prices having moved sideways or even weakened since the beginning of 2004. On the other hand, long-term benchmark interest

Box I.1. Policy and other assumptions underlying the central projections¹

Fiscal policy assumptions are based as closely as possible on legislated tax and spending provisions (current policies or “current services”). Where policy changes have been announced but not legislated, they are incorporated if it is deemed clear that they will be implemented in a shape close to that announced. For the present projections, the implications are as follows:

- For the United States, the projection incorporates the defence appropriations for fiscal year (FY) 2005 enacted in August 2004 and anticipates a further \$30 billion budget request in FY 2005 for military operations and reconstruction in Iraq and Afghanistan; thereafter funding requirements for these operations are assumed to decline. The projection also embodies the extension of the personal income tax provisions originally scheduled to expire at the end of 2004 and of the temporary indexation of the alternative minimum tax, as well as the American Jobs Creation Act passed in October 2004.
- For Japan, the projection takes into account the 2004 pension reform, which increases contributions by individuals and employers in every year from FY 2004 to FY 2017, as well as the recent broadening of the direct and indirect tax bases. No supplementary budgets are assumed to be implemented over the projection period.
- In the European Union, the projection for Germany takes into account the cuts in income taxes, subsidies and tax expenditures scheduled to take effect in 2005. For France, it is assumed that public employment and health care outlays are held in check. For Italy, it is assumed that the caps on public spending announced in the 2005 draft budget will be broadly adhered to in 2005-06. For the United Kingdom, the projection rests on the premise that the government’s nominal expenditure plans are broadly realised, but that the elasticity of revenue will be somewhat weaker than budgeted.

Policy-controlled interest rates are set in line with the stated objectives of the relevant monetary authorities with respect to inflation and activity:

- In the United States, the federal funds target rate, which since mid-2004 has been raised in 25 basis point steps from 1 to 2 per cent, is assumed to increase gradually towards its neutral level (see Box I.4), and to reach 4 per cent towards the end of the projection period.
- In the euro area, the main refinancing rate, which has remained unchanged at 2 per cent since it was cut by ½ percentage point in June 2003, is assumed to start rising in early 2006, moving back to 3 per cent by the end of the projection period, against the background of persistent economic slack. Policy rates have already been raised by 125 basis points in the United Kingdom over the past year, and a further 100 basis point increase is built into the projection.
- In Japan, short-term interest rates are assumed to remain close to zero through the end of 2005 and to inch up in 2006, to ½ per cent by end-year, as consumer price deflation ends.

The projections assume unchanged exchange rates from those prevailing on 5 November 2004, at one US dollar equals ¥ 105.7 and € 0.771. For Turkey, the exchange rate is assumed to depreciate in line with the projected inflation differential *vis-à-vis* the United States.

As a working hypothesis, the price of Brent crude is assumed to decline linearly from \$47 per barrel in late 2004 to \$44 at the end of 2006. This is in line with the assumption underpinning the OECD’s medium-run baseline scenario that the price of oil will gradually revert towards its long-term equilibrium level, as risk premia and other temporary factors abate. The posited decline is also broadly consistent with what recent far futures quotes have suggested.² Commodity price inflation is assumed to begin easing in the course of the projection period.

The cut-off date for information used in the projections is 18 November 2004.

1. Details of assumptions for individual countries are provided in Chapter II.

2. See Chapter IV, “Oil price developments: drivers, economic consequences and policy responses”.

rates have eased significantly since the second quarter of 2004, while corporate bond spreads have remained quite narrow, although this partly denotes more subdued animal spirits. Recent exchange rate movements are helping growth and external adjustment in the United States but cutting into the contribution of the external sector to the expansion in the euro area and Canada.

In the United States, the output gap is projected to close over the projection period, with job creation picking up but the employment rate remaining some 3 percentage points below the peak of the late 1990s. Firms have taken advantage of the prolonged spell of historically low interest rates to strengthen their balance sheets and enjoy ample profits.⁹ This should allow for robust business spending, despite the expiration of temporary tax incentives favouring investment,¹⁰ and make for increased hiring. Residential investment is projected to stabilise, as long-term interest rates rise. Household consumption will no longer be boosted by tax refunds and declining mortgage payments, and will therefore be more dependent on employment growth. Given that the household saving ratio is already low by historical standards, and on the premise that equity and housing wealth will not rise faster than income, consumption is unlikely to receive a fillip from a further decline in the propensity to save. The external sector is projected to become less of a drag on GDP growth as export volumes continue to expand rapidly and imports decelerate somewhat. Productivity gains, having recently declined markedly, should settle around rates closer to long-run averages and core inflation should remain muted.

US growth will continue to be led by business investment...

In the euro area as well, the expansion will be restrained by higher oil prices in the short run. But beyond that the recovery should broaden. For the area as a whole, final domestic demand should accelerate, with real GDP growth in Germany and the Netherlands gradually catching up. The conditions are favourable for business investment to pick up, given improved profitability, low real long-term interest rates and the restructuring of corporate balance sheets (although this has not proceeded as far as in the United States). Overall, the output gap is projected to narrow in 2005-06, but not fast enough for it to close. In the course of the upturn, hiring is projected to pick up only slowly, with the acceleration in output translating more into productivity gains and rising hours worked than job creation. Indeed, the resilience of employment during the slowdown – compared with both earlier slowdowns in the euro area and labour market behaviour elsewhere – may have reflected greater labour hoarding and reductions in hours worked per employee, as well as public subsidisation of certain types of jobs. Accordingly, the unemployment rate is not expected to decline substantially before 2006. For the euro area as a whole, wage moderation should be an enduring feature, but the structural competitiveness problems facing Italy in export markets are expected to persist (Figure I.8). Inflation should ease, as the energy price shock falls out and on the assumption that food price, indirect tax and other shocks witnessed in the recent past do not recur.

... whilst in the euro area domestic demand will gradually strengthen

9. US non-financial corporations have brought down their debt-to-asset ratio to its lowest level in two decades, whilst lengthening the average maturity of their debt. Moreover, firms with floating-rate debt have used interest-rate derivatives to reduce their interest rate exposure, see Covitz, D. and S. Sharpe, "Which firms use interest rate derivatives to hedge? An analysis of debt structure and derivative positions at nonfinancial corporations", Federal Reserve Board, *mimeo*, September 2004.

10. The partial-expensing provision expiring at the end of 2004 provides an incentive to firms to invest in new capital goods. However, evidence relating to the quantitative effect of this tax measure is not clear-cut. If its impact is limited, its removal may not slow investment much.

Box I.2. Has there been a lasting shift in Japanese consumer behaviour?

The saving rate has been falling. The household saving rate in Japan, which has traditionally been among the highest in the OECD area,¹ declined sharply throughout the 1990s. By 2002 the net household saving rate stood at around 5 per cent of GDP and somewhat below the median for OECD countries.² The declining saving rate has supported consumption through the current expansion. While it is difficult to forecast how the saving rates will evolve, several forces influencing saving and consumption tend to suggest that the risk of a backup in household saving may be limited.

Population ageing is pushing the household saving rate down. The rapid ageing of the population is one important factor pushing down saving rates. Consistent with the life-cycle hypothesis, as the elderly enter retirement they begin to dissave. Due to the fall in the fertility rate, the cohort of workers entering the peak saving ages is too small to offset the decline in aggregate saving rate driven by the rising share of the elderly in the population. Expected demographic trends would suggest that there will be continued downward pressure on the household saving rate.³

Labour market developments are less negative. Full-time employment has fallen by over 5 million since the mid-1990s while part-time employment has risen by almost 4 million and now accounts for over 27 per cent of total employment. These changes on the labour market have allowed firms to reduce unit labour costs and, by driving down the labour share, have put downward pressure on disposable income growth, while also acting as an incentive to increase precautionary saving. This influence may now be abating. For full-time employees, labour market developments in 2004 point to a stabilisation, with posts expected to remain constant for the first time since the beginning of the decade. Insofar as this reduces employment uncertainty and increases consumer confidence, it will encourage households to reduce their precautionary savings.⁴ The confidence of those currently on short-term contracts may also benefit from a continuing contraction in labour supply.

The corporate recovery is increasing retained profits and creates positive wealth effects. The decade of the 1990s was

one of negative wealth effects from declining equity and land prices, which would, *ceteris paribus*, have acted to push the saving rate up. Now, as company profits rise, household consumption expenditure may be spurred by more positive – or less negative – wealth effects. However, equities have a small weight in Japanese household portfolios, which remain dominated by land and, to a lesser extent, housing wealth. So far, land and house prices have continued to decline, thereby offsetting the wealth effect stemming from households' financial assets.

Real interest rates are falling and deflation is abating. The impact on household saving of the deflation and high real long-term interest rates that prevailed during the 1990s is ambiguous. On the one hand, high real rates and the anticipation of lower prices would have created incentives to defer consumption. But the spending power of savers would have increased via positive “real balance” effects: the purchasing power of money balances rises with deflation, so that households can save less and still attain a given level of future consumption. These positive wealth effects would have offset the negative effects of falling equity and land prices. As deflation ends, the situation will reverse, to a degree dependent on how household portfolios adapt.

Fiscal consolidation would reduce upward pressure on private saving. Government debt as a share of GDP increased substantially over the 1990s and the anticipation of higher future taxes due to this trend would have acted, other things being equal, to push up the private saving rate. The social security system has recently experienced its first current deficits and there is, indeed, evidence of younger cohorts saving earlier and at higher rates than their predecessors, related to fears about income adequacy on retirement and scepticism over the financial sustainability of the public pension system.⁵ However, if the government sticks to or accelerates its announced commitment to move gradually towards budget balance over the next decade, the perception of households' that the course of public finances is unsustainable may lessen, reducing the perceived need to save.⁶

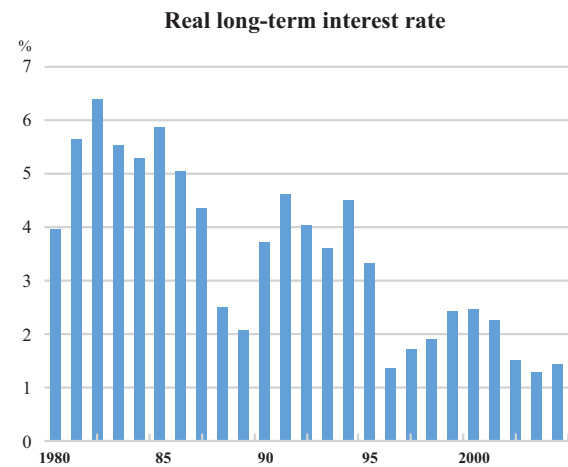
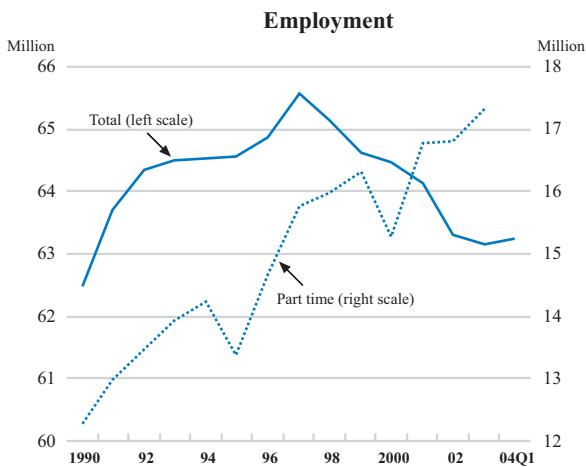
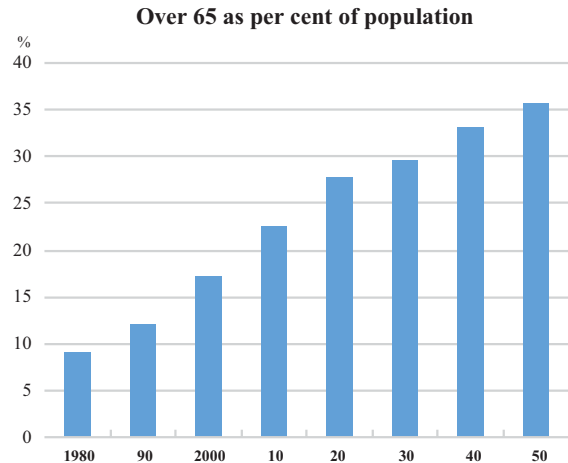
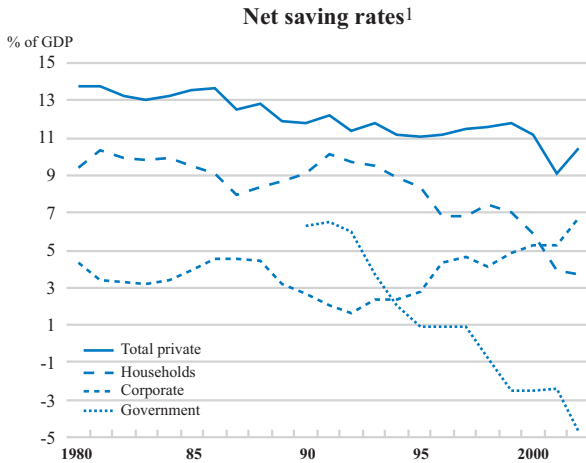
1. For a retrospective review of factors advanced to explain the “high” Japanese saving rate, see Horioka, C., “Are the Japanese unique? An analysis of consumption and saving in Japan”, Osaka University, *mimeo*, 2004.
2. More recent evidence from flow-of-funds statistics suggests that the household saving rate fell further until the end of 2003.
3. Kozu, T, Y. Sato, and M. Inada, “Demographic changes in Japan and their macroeconomic effects”, *Bank of Japan Working Papers*, No. 04-E-6, 2004.
4. See Doi, T., “Precautionary saving and employment risk during the 1990s”, *PRI Discussion Paper Series No.04A-03*, Ministry of Finance, 2004, who points to evidence that some households increased precautionary saving in response to uncertainty resulting from labour market adjustments.
5. According to survey evidence, 70 per cent of respondents were in favour of drastic reform to the national pension scheme (<http://globalag.igc.org/pension/world/2004/drastic.htm>). On the saving rates of different cohorts, see Ishikawa, T., “Has the saving behaviour of Japanese households changed? Distinguishing facts from fallacies”, *NLI Research*, 2004.
6. See Chapter V, “Saving behaviour and the effectiveness of fiscal policy”.

Box I.2. Has there been a lasting shift in Japanese consumer behaviour? (cont.)

In sum, the ongoing effects of population ageing will maintain downward pressure on household saving at a time labour market developments, wealth and fiscal consolidation effects are also beginning to move in a direction that reduces

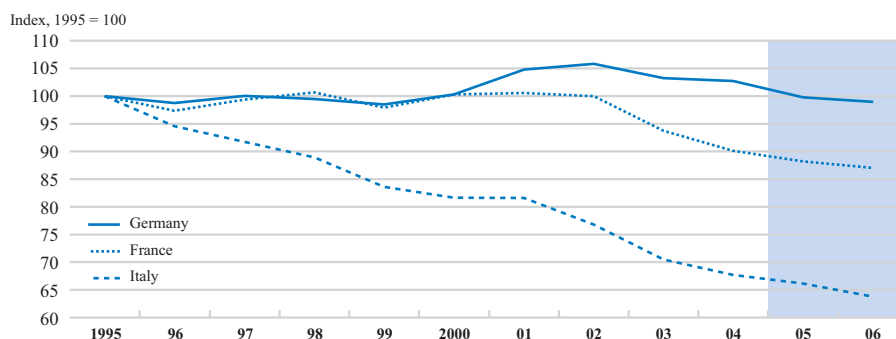
the risk of a backup in household saving. The end of deflation could in principle curb the incentives for households to save, but the net impact of lower real interest rates and lower real balance effects is uncertain.

A variety of forces influence household saving



1. Net of consumption of fixed capital.
 Source: OECD Annual National Accounts, 1970-2002; Statistics Bureau, Ministry of Internal Affairs and Communications, *Statistical Handbook of Japan*, 2004; OECD Labour Force Statistics, October 2004; OECD Economic Outlook 76 database.

Figure I.8. Export performance is diverging among the larger euro area economies



Note: Export performance is an index of exports relative to weighted import demand of trading partners. It is based on national accounts data for trade of goods and services.

Source: OECD Economic Outlook 76 database.

In Japan, the expansion is set to continue

In Japan, growth should settle at a rate somewhat above potential. As firms have restored profit margins, the expansion should be supported by business investment, whilst the role of exports should diminish. Indeed, foreign demand, notably from China, has slowed and, as noted, the high-tech cycle seems to have peaked. The household saving rate is projected to stabilise (Box I.2), but consumer spending will be sustained by employment creation and fading wage deflation. Consumer price inflation should turn marginally positive in the course of the projection period, as unemployment gradually declines towards its estimated structural rate.

Non-OECD countries should see sustained growth...

The impulse to global growth from the non-OECD area should continue to be significant. In China, the projection for the next two years remains one of sustained real GDP growth, even if most risks seem to be on the downside.¹¹ In Russia, growth is projected to moderate, in line with a slower expansion of the oil sector and notwithstanding considerable terms-of-trade gains. In Brazil, where exports have led the recovery so far, domestic demand is strengthening so that growth is becoming more broadly based.

... and world trade will continue to expand rapidly

Following a slowdown in the course of 2004 – especially in Dynamic Asia and China – world trade is projected to expand by around 9 per cent in 2005 and to maintain this pace in 2006 (Table I.3), which would be distinctly above the long-run average. With a lag of a few quarters, a significant portion of the extra oil revenues enjoyed by oil exporters should be spent on imports from OECD countries: Turkey should benefit most in terms of export market growth, with a 2½ percentage point gain, whilst Australia, France, Greece, Italy and the United Kingdom would all record a gain of over one percentage point. As discussed below, trade and current account imbalances are projected to persist or worsen.

11. See Chapter III, “Developments in selected non-member economies”.

Table I.3. World trade growth should be sustained

	2003	2004	2005	2006
Percentage change over previous period				
Goods and services trade volume				
World trade ^a	5.1	9.5	9.0	9.5
of which: OECD	3.0	8.4	7.7	8.1
NAFTA	2.5	9.6	8.3	8.0
OECD Asia-Pacific	8.7	13.6	9.0	9.9
OECD Europe	1.8	6.4	7.0	7.6
Non-OECD Asia	12.2	14.0	12.9	13.8
Other non-OECD	7.9	9.5	10.5	11.2
OECD exports	2.4	8.3	7.8	8.5
OECD imports	3.6	8.4	7.6	7.7
Trade prices^b				
OECD exports	11.5	8.4	4.7	0.9
OECD imports	10.6	8.6	5.3	1.0
Non-OECD exports	6.1	10.0	6.6	2.1
Non-OECD imports	6.6	8.0	4.9	2.6
Current account balances				
Per cent of GDP				
United States	-4.8	-5.7	-6.2	-6.4
Japan	3.1	3.5	3.5	3.7
Euro area	0.4	0.7	0.6	0.9
OECD	-1.1	-1.2	-1.4	-1.3
\$ billion				
United States	-531	-669	-761	-825
Japan	135	164	168	184
Euro area	32	67	61	96
OECD	-338	-395	-483	-482
Non-OECD	250	308	361	316
World	-88	-87	-122	-166

Note: Regional aggregates include intra-regional trade.

a) Growth rates of the arithmetic average of import volumes and export volumes.

b) Average unit values in dollars.

Source: OECD Economic Outlook 76 database.

In the near term, risks are dominated by oil price uncertainty

The single most prominent uncertainty surrounding the above projections pertains to the oil price. Others include those on the geopolitical front and concerning the emergence of protectionist tensions, which would complicate Doha Round negotiations. Some of the downside risks highlighted in earlier editions of the *OECD Economic Outlook* have become more acute, notably as house prices have begun to stall. Where house price rises have been related to speculation, the adjustments may still have further to go than posited in the projection. Other risks have not crystallised, but nor have they disappeared, in particular those related to a possible backup in long-term interest rates or to a hard landing of the Chinese economy. On the upside, there is a possibility that the balance sheet purge associated with the latest global slowdown has set the stage for a more forceful investment performance than projected.

Oil price uncertainty casts a shadow over the projections

The oil price could fall back significantly, consistent with the fact that spot oil prices appear to have been boosted by a number of short-run factors (Box I.3), but it could also turn out to be higher and more persistent than expected. The low

Oil prices may surprise either way

Box I.3. Have oil prices overshot?

Will higher oil prices persist? Oil price volatility has increased gradually over the past decade and in this context substantial spikes to the oil price are not particularly unusual. Over the same period, the persistence of oil price shocks has diminished, though *ex ante* it is difficult to determine whether an oil price shock is permanent or transitory. In this context, with oil prices in 2004 reaching levels that have not been seen since the oil price shocks in the 1970s and early 1980s, the question arises whether oil prices will remain this high or revert towards their longer-term trend.

Short-term futures reflect temporary risk premia and speculation. With respect to the short-term futures price, the oil market has been in almost continuous strong backwardation since 1999, the spot price being significantly higher than the six-month futures price. This is an unusually long period and suggests that current uncertainties are adding a large risk premium to the spot price. During 2004, fears over the security of supply have surfaced with regularity. Indeed, risk premia have risen with fears of supply disruptions arising from the sabotage of Iraq's oil export infrastructure, attacks on oil workers in Saudi Arabia, the uncertainty over the future of the Russian oil company Yukos (which accounts for almost 2 per cent of world production), and threats of supply disruptions in Nigeria and Venezuela. The impact of speculation on oil prices is harder to quantify, but may also account for some of the volatility.

Industry stocks have been low. With strong demand and supply tight, even small perturbations to the oil market can induce substantial price movements. In such a volatile market, industry participants have higher desired levels of inventories, and require a larger spot price increase, relative to the forward price, to release stocks to the market. This is the case at the moment. Oil industry stocks, having trended downwards over

the 1990s, have been low in relation to demand and have reduced the flexibility of supply, but the demand for stocks has built up over the year, putting pressure on the oil price.¹

Demand for oil has been stronger than anticipated. As uncertainty dissipates, the oil price will fall. However, some influences appear likely to be long-lasting. Over the first half of 2004, strong demand contributed to the strengthening of oil prices. The composition of oil demand in early 2004 reflected stronger than anticipated output growth in dynamic Asian economies, and particularly China. The dynamic Asian economies and China accounted for almost one half of the additional demand, with outturns somewhat higher than industry projections made at the beginning of the year. Pressures from the demand side are likely to continue, though if high prices persist the higher long-term price elasticity of demand will lead to lower demand in the future.

Low investment means production capacity is tight. Spare capacity in OPEC countries – principally in Saudi Arabia – has been reduced over the course of the year. As a result, it is estimated that spare capacity in OPEC countries has narrowed to around 1 million barrels per day.² At the same time, there has been little spare capacity available outside the OPEC producers to respond to surges in demand. More recently, in the context of expectations of rising oil prices, investment in exploration and development in non-OPEC countries has picked up relative to activity in the 1990s. But lead times in bringing additional supply to market mean that such investment does little to alleviate pressure in the short run, implying a comparatively inelastic short-run elasticity of supply. In short, without the increased development of OPEC producers' substantial reserves, supply is likely to remain tight for some time to come.

1. During the course of 2004 stocks attained levels that are similar for the same time of year in comparison with the recent past. But strong backwardation persisted over this period and created incentives to run down stocks. In this light, a "normal" level of stocks is likely to be higher than comparison with the recent past would suggest. Other temporary influences on stock levels include the impact of the hurricane season, which by reducing offshore production and delaying shipments to the United States reduced stock levels.

2. As recently as 2002, OPEC spare capacity exceeded 6 million barrels per day.

short-term elasticity of demand implies that supply disruptions reducing daily output by no more than one or two million barrels could lead to substantially higher oil prices.¹² The actual size of a possible further adverse oil price shock would, however, depend on its source, oil reserves being relatively concentrated geographically. Standard simulations using the OECD's Interlink model allow a rough quantification of the first-round demand-side effects of an oil price shock of the current magnitude, and the impact of policy responses, based on average behaviour during past episodes. Under the assumption that nominal interest rates are unaffected, they suggest that a

12. For further details, including simulations of the macroeconomic impact of oil price shocks, see Chapter IV, "Oil price developments: drivers, economic consequences and policy responses".

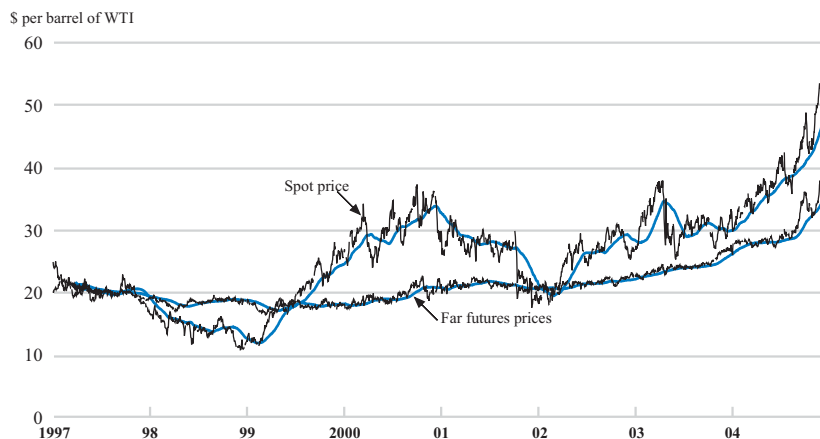
Box I.3. Have oil prices overshot? (cont.)

Far futures prices have risen. While price projections for a volatile market are very uncertain, and near-futures prices are poor predictors of the future spot price, several indicators point to expectations that as the influence of short-term factors abates, oil prices will be permanently higher. Far futures prices (six to seven years out) have risen, whereas, throughout the 1990s, prices for the longest available futures remained very stable at around \$20 per barrel. Moreover, oil company analysts have raised their longer-term price expect-

tations by around \$5 per barrel since the beginning of the decade. Equity investors' valuations of oil company assets have also apparently risen, in line with expectations of higher oil prices.³ Taken together, these factors suggest that, though prices will fall from current levels as the impact of short-term factors dissipates, some elements behind the recent rise will have a longer-lasting impact.⁴ Most importantly, the longer-run elasticity of demand and supply for oil is higher than the short-run elasticity.

Crude oil spot and far futures prices

West Texas intermediate (WTI), current dollars, and three-month moving average



Source: Datastream.

3. See, for example, Randall & Dewey, *Global Acquisitions Review*, Third Quarter, 2004.

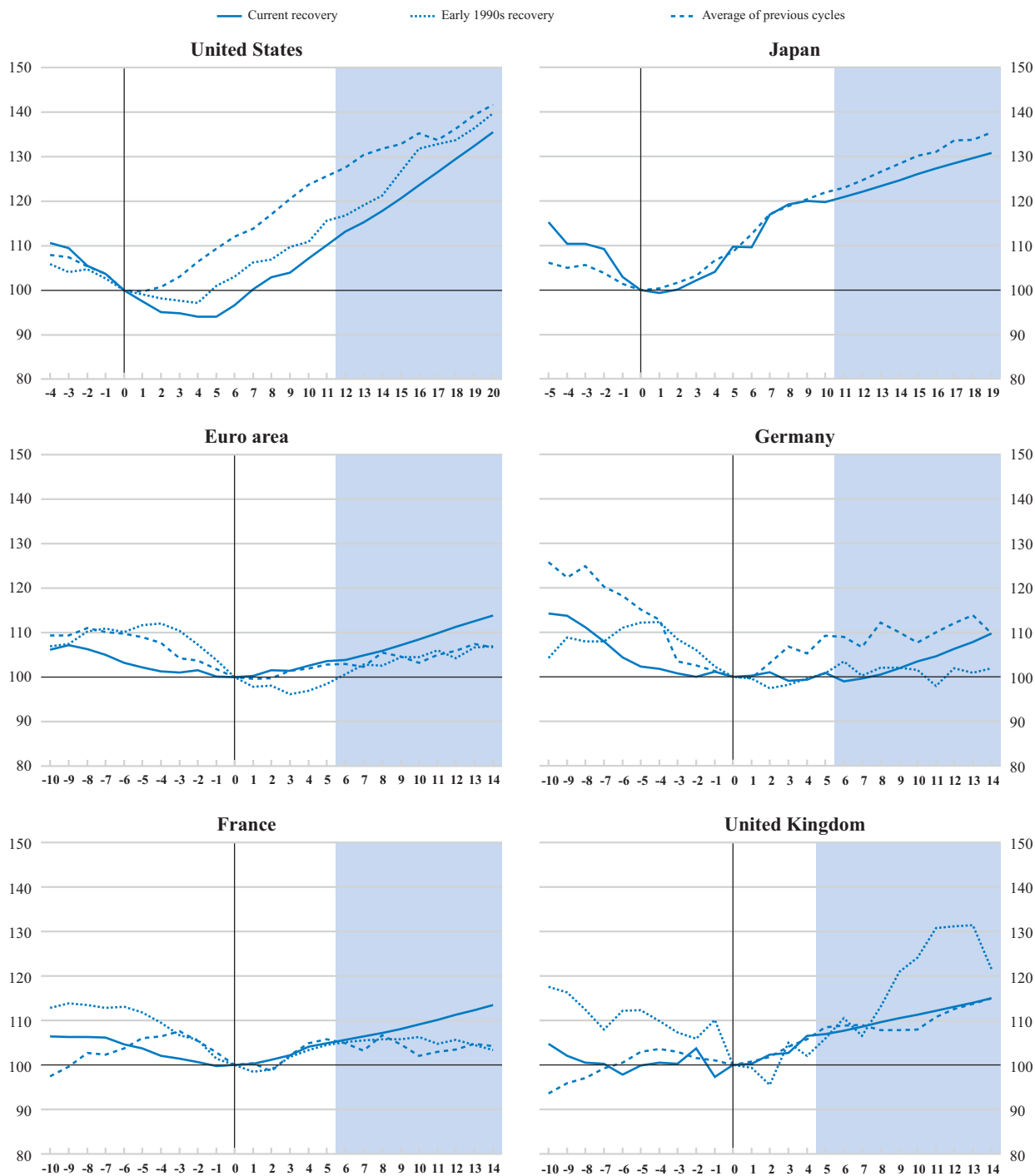
4. See Chapter IV, "Oil price developments: drivers, economic consequences and policy responses".

sustained \$15 increase in oil prices – from the middle of the range targeted by OPEC in the past to \$40 – subtracts some 0.2 percentage point from OECD-wide real GDP growth in the first full year. They also point to a concomitant rise in consumer price inflation of a slightly greater magnitude. Such simulations do not capture possible negative longer-run supply-side effects stemming from a lower return on capital, or the non-linearities which come into play in the event of a large price shock having an impact on confidence.¹³

13. In particular, ready reckoners tend to mask possible asymmetries, insofar as a \$10 oil price increase may have stronger effects on output and inflation -- in absolute terms -- than a \$10 decrease.

Figure I.9. Investment has been picking up slowly in some countries

Business sector investment, index, cyclical trough = 100



Note: A cyclical trough is usually defined as a trough in the level of real GDP. For the United States the NBER chronology is used. For the United Kingdom, the last cyclical trough reflects a minimum in the output gap. The average of previous cycles includes major cycles from the 1960s to the 1980s (late 1970s to 1990s for Japan). The last cyclical trough is 2001Q4 for the United States, 2002Q1 for Japan and 2003Q2 for the European countries. The shaded area shows the projection period for the current cycle.

Source: OECD Economic Outlook 76 database.

So far, investment has performed differently from past cycles, but not uniformly so. In the United States and Germany, it has been slower to pick up than usual, unlike in Japan, the United Kingdom and other members of the euro area (Figure I.9). Provided oil prices evolve favourably, there is an upside risk that flush corporate balance sheets and profits in the United States and several other large OECD economies may translate into stronger investment and hiring than in the projection, not least in view of the very large slump in investment during this downturn but also considering possible increases in scrapping rates related to a larger proportion of high-tech equipment. The upside risk to investment would be all the more significant if long-term interest rates were to remain below their assumed path, or if equity prices were to bounce back.

Investment could be stronger than expected...

However, long-term benchmark interest rates are currently very low, possibly reflecting some flight to safety, which makes for a rather flat yield curve at this stage of the cycle. At the same time, spreads on corporate bonds are far below recent historical averages. Hence, there is a risk of a more abrupt rise in interest rates than foreseen in the projection.¹⁴ This risk is aggravated by a backdrop of persistent, large fiscal imbalances, insofar as they may not have been fully priced in.

... but long-term interest rates could back up more abruptly than foreseen

In recent years, many countries have seen house prices far outpace consumer prices (Figure I.10). The associated wealth gains have helped to support household spending, especially where institutional arrangements are conducive to housing equity withdrawal in one form or another.¹⁵ In a number of cases – notably Australia, Ireland, New Zealand, Spain and the United Kingdom – real estate prices have reached very high levels compared with rents or incomes and house prices seem, in fact, to have peaked in several of these countries. To the extent that this is a response to moderate monetary tightening, it may be seen as the counterpart to the resilience generated by the housing market during the cyclical downturn. Yet, even if they may not decline in absolute terms, more stable house prices imply that an important driver of household spending is no longer operative, or much less potently so, creating a drag on growth, as evidenced in the Netherlands and, most recently, in the United Kingdom.¹⁶ Concerns have mounted regarding the risk of an abrupt housing market slowdown, in a context where house price rises may have been driven by speculative behaviour, especially where households have taken on considerable debt.

Rapid house price inflation may have ended in several countries

The importance of the Chinese economy for OECD countries, particularly via trade channels, has rapidly increased over time. In 2002-03, growth in Chinese imports accounted for one-fifth of export market growth in the United States, one-quarter to one-third in Japan and Australia and two-fifths in Korea.¹⁷ While this

A hard landing in China would mostly, but not only, affect Asia

14. For further discussion, see Sløk, T. and M. Kennedy, “Factors driving risk premia”, *OECD Economics Department Working Papers*, No. 385, 2004.

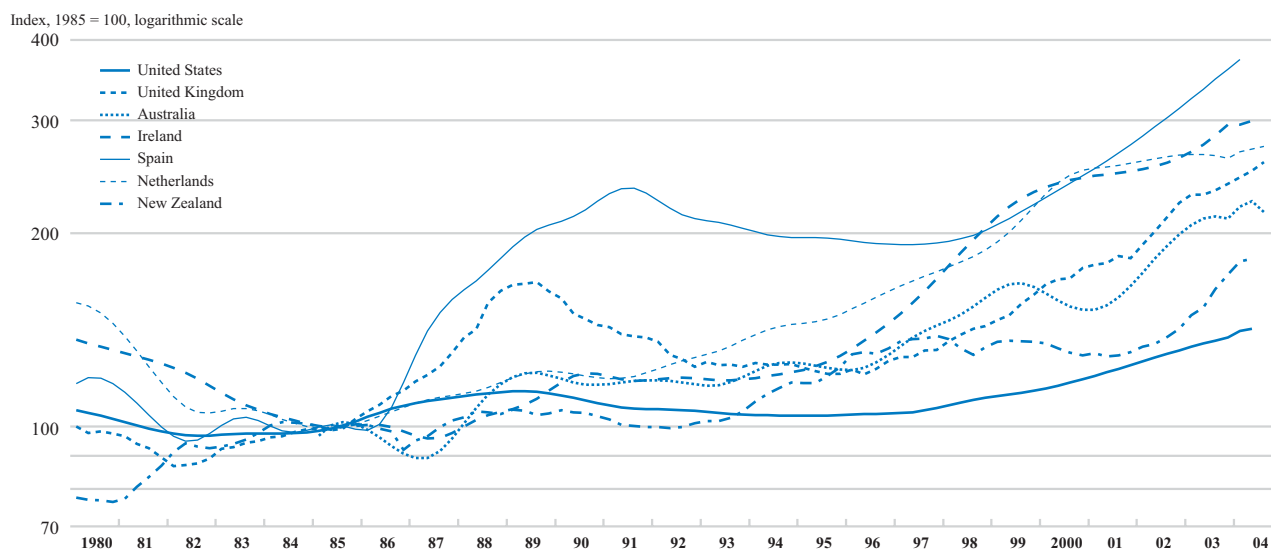
15. See Catte, P., N. Girouard, R. Price and C. André, “The contribution of housing markets to cyclical resilience”, *OECD Economic Studies*, No. 38, 2004/1. Only part of withdrawn equity, however, is consumed in the near term: e.g. households selling a property without purchasing another one and those who trade down are more likely to pay off debt or save the proceeds than to spend them (see Benito, A. and J. Power, “Housing equity and consumption: insights from the Survey of English Housing”, *Bank of England Quarterly Bulletin*, Vol. 44, No. 3).

16. It has been estimated that housing equity withdrawal has contributed about 1 percentage point to Dutch real GDP growth both in 1999 and in 2000, but that as equity withdrawal subsequently halved, its contribution turned negative, subtracting ½ percentage point from real GDP growth both in 2001 and in 2002, and exerting a further drag in 2003 (“Financial behaviour of Dutch households”, De Nederlandsche Bank, *Quarterly Bulletin*, September 2003). The potential negative contribution of a slowdown in house price inflation in the United Kingdom is quantified in the latest *OECD Economic Survey of the United Kingdom*, Paris, 2004.

17. The impact on the market growth facing producers in the major European economies was smaller, at around one-tenth, as they tend to trade less heavily with China, with Germany nonetheless relatively more exposed.

Figure I.10. Real house prices may be peaking in some countries

Nominal price deflated by the overall consumer price index



Source: Australian Commonwealth Bank Housing Industry Association; Bank of Spain; Irish Department of the Environment; UK Office of the Deputy Prime Minister; US Office of Federal Housing Enterprise Oversight; Reserve Bank of New Zealand; OECD, *Main Economic Indicators*.

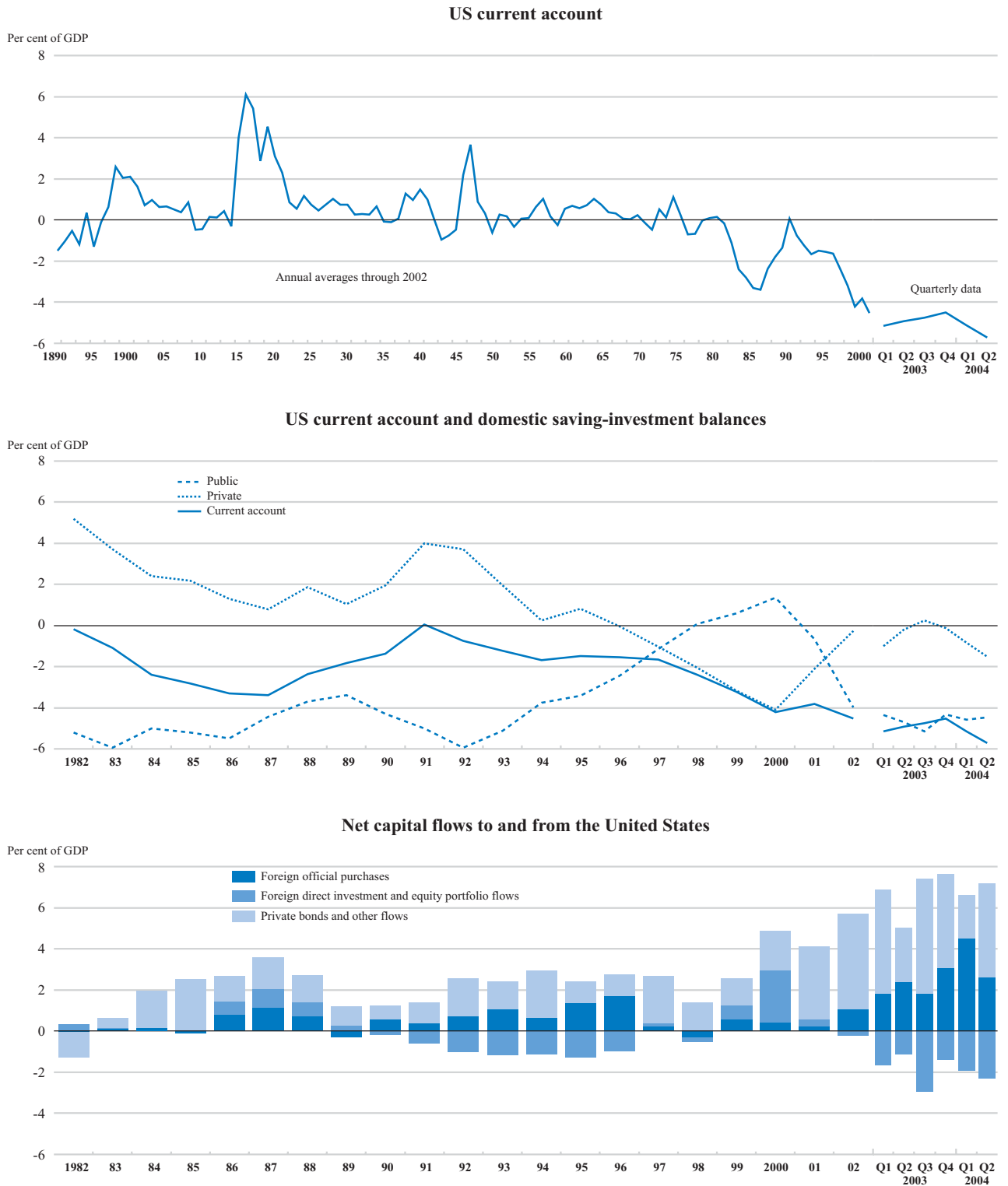
proportion is declining somewhat, reflecting a pick-up in trade in other parts of the world, China's contribution to world trade growth is likely to remain well above its global export share. Thus, in the event of a hard landing in China – possibly precipitated by a more abrupt than foreseen end to over-investment or by higher oil prices (given China's greater dependence on oil) – the associated slowdown in imports would noticeably affect the export market growth of OECD economies. The direct impact would depend not only on the extent to which they trade with China, but also on the importance of external trade for the overall economy. More open economies may be more affected than others, even if they trade less heavily with China. For example, the drag on Canadian GDP of weaker growth in Chinese imports in 2004-05 would be approximately double that on US GDP, even though China accounts for a larger proportion of US exports. At the same time, an abrupt deceleration in China would reduce demand pressures in energy and raw materials markets, which would entail terms-of-trade gains for many OECD countries.

External imbalances will get larger

Sizeable external imbalances are projected to persist in a number of OECD countries, most notably in the United States, where the current account deficit is set to worsen from $4\frac{3}{4}$ per cent of GDP in 2003 to $6\frac{1}{4}$ per cent by 2006, with as its main domestic saving/investment counterpart persistent public dissaving (Figure I.11). In stock terms, non-residents are estimated to currently own some \$10.5 trillion in US assets, implying that shifts in the US dollar exchange rate could have sizeable effects on balance sheets abroad. In net terms, US foreign liabilities, which at end-2003 amounted to 23.5 per cent of GDP, are projected to double by the end of the decade assuming unchanged policies and exchange rates.¹⁸ Current account deficits of this

18. See Brook, A-M., F. Sédillot and P. Ollivaud, "Channels for narrowing the US current account deficit and implications for other economies", *Economics Department Working Papers*, No. 390, 2004.

Figure I.11. The US current account has entered uncharted territory



Source: US Bureau of Economic Analysis; Bureau of the Census: *Historical Statistics of the United States*, Washington DC, 1975.

order of magnitude can be sustained for some time. A case in point is Australia, where the current account gap has averaged 4½ per cent of GDP over the past two decades. However, Australia's economy is only one twentieth as large, so that the share of claims on Australia in foreign investors' portfolios is bound to remain modest. Moreover, the domestic counterpart has been private investment rather than government dissaving. While the US external deficit was mostly financed by direct and portfolio equity investment in 2000, its funding has shifted towards purchases of bonds issued by the government or government-sponsored agencies, with a sizeable share of these purchases emanating from central banks, mostly in Asia. How long such a configuration can endure cannot be predicted, but debt accumulation at the current pace cannot continue indefinitely. When it ceases, this could well involve potentially disruptive downward pressure on the dollar and upward pressure on bond yields.

At what pace should macro stimulus be removed?

Macroeconomic policy stimulus should be withdrawn gradually

While, as noted, the impulse to growth from fiscal and monetary policies is diminishing, the macroeconomic policy stance remains quite loose in most OECD countries. As the recovery broadens, the degree of policy accommodation needs to be reduced gradually, not just to avoid procyclical stimuli but also, on the fiscal side, to address increasingly pressing medium-run challenges. However, while a movement towards a more neutral interest rate setting is projected, on current fiscal plans little consolidation is set to take place over the next two years (Figure I.12).

Monetary policy: returning to neutrality

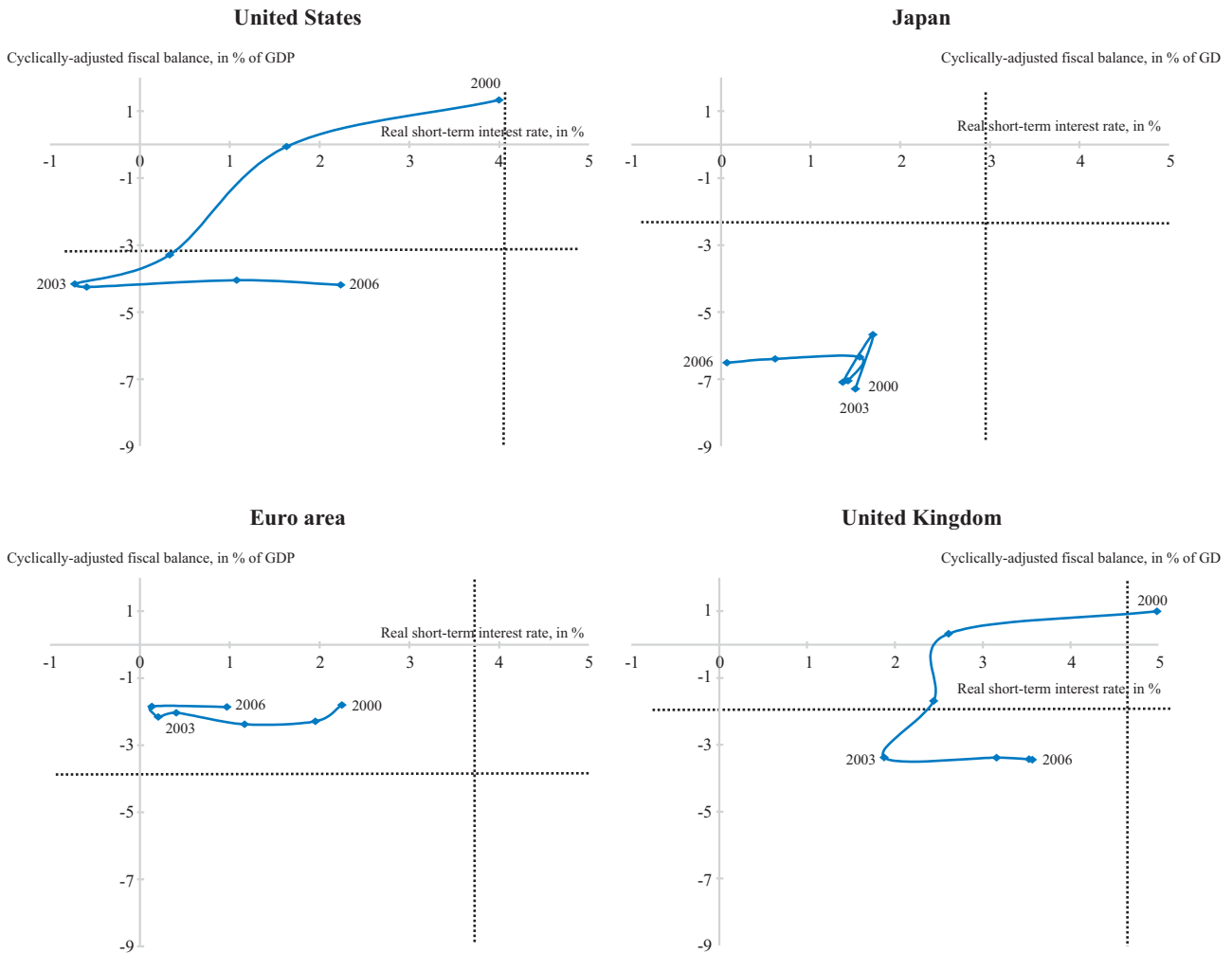
Central banks have started to raise interest rates...

Most OECD central banks loosened the monetary policy stance following the onset of the latest cyclical slowdown. As a result, ample liquidity was created, and real interest rates were maintained at low levels for quite some time (Figure I.13). This helped support the recovery in the face of geopolitical and other headwinds. However, in order for the resulting liquidity not to fuel an unwelcome upsurge in inflation over the medium run, a gradual withdrawal of stimulus is called for, albeit with different timing and speed across regions, taking into account continuing headwinds, not least those stemming from oil prices. In general, the pace at which interest rates should be normalised need not be influenced by the first-round impact of energy price increases on headline inflation, insofar as longer-run inflation expectations have remained well-anchored around central banks' desired levels. The move toward a more neutral stance has already started in the United States, the United Kingdom and some smaller economies (*e.g.* Canada, New Zealand, Poland and Switzerland) where slack, if any, is limited and/or some inflationary pressures are surfacing. In contrast, the need to steer interest rates upwards is less urgent in the euro area and Japan.

... in the United States and the United Kingdom...

Since the previous *OECD Economic Outlook*, the US Federal Reserve has raised its key policy rate four times, in steps of 25 basis points each, to 2 per cent. Even so, both nominal and real interest rates remain very low in historical perspective. In a context where the output gap is shrinking and unit labour costs are picking up, further increases are warranted to bring rates closer to a neutral position

— Figure I.12. Monetary stimulus is being withdrawn at an uneven pace and fiscal adjustment is wanting —



Note : In each panel, the dotted lines represent the 1980-2000 averages for short-term real interest rates and the cyclically-adjusted fiscal balance.
 Source: OECD Economic Outlook 76 database.

(Box I.4). As corporate balance sheets have been consolidated substantially in recent years, and given comfortable profit levels, firms should be able to withstand the normalisation of interest rates with relatively little stress (see Appendix). Policy rates have also continued to be raised in small increments in the United Kingdom, but to a much higher level of 4¾ per cent, in a context where the output gap is turning positive. The tightening of the monetary stance, which started a year ago, has contributed to the slowing of house price inflation, but credit to households remains buoyant. In all likelihood, the policy rate is nearing neutrality and with consumer price inflation still surprisingly subdued, only limited further interest hikes seem warranted.

In contrast, the key policy rate has remained on hold in the euro area since June 2003, at 2 per cent. Over the same period, however, monetary conditions – as measured by the weighted average of real short-term interest rates and the real effective exchange rate – have tightened somewhat. For reasons discussed above, headline inflation has exceeded the Eurosystem’s 2 per cent threshold almost unin-

... but interest rates remain on hold in the euro area...

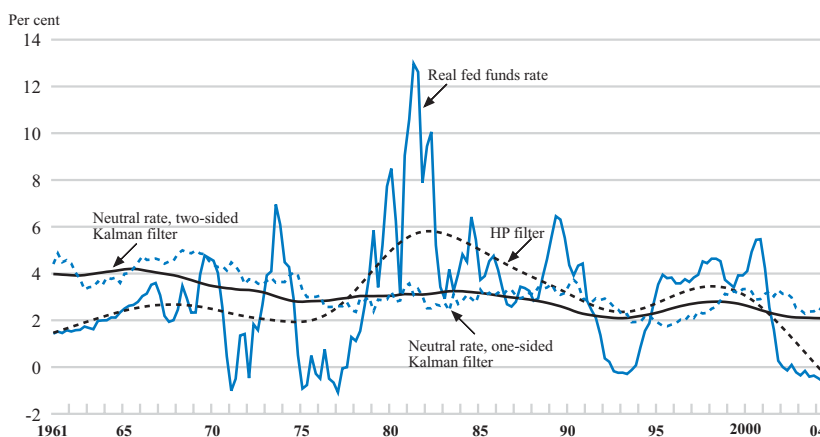
Box I.4. Where does the “neutral” interest rate lie?

The “neutral” rate is an important conceptual benchmark. As policy-controlled interest rates start to move up from very low levels, the question arises of where their “equilibrium”, “natural” or “neutral” level may lie. In its contemporary form, this concept refers to the interest rate consistent with output at potential and stable inflation. It plays a key role in some models of central banks’ reaction function, such as the so-called Taylor rule, or when computing indicators of future inflationary pressures such as the real interest rate gap, understood as the difference between the observed and the neutral rate.¹ Below, the term “neutral rate” will be used as short-hand for the neutral short-term real interest rate.

Long-term averages and univariate estimates of the neutral rate can be misleading. Empirically, the neutral rate has been derived in a variety of ways. The simplest approaches

are univariate and capture it as some long-run average of observed values (possibly with a greater weight on recent observations), or run a filter through the real interest rate data to obtain it as a relatively smooth trend – for example a Hodrick-Prescott (HP) filter. Such approaches do not incorporate the interactions between interest rates on the one hand and inflation and output on the other, and can therefore be misleading. They may make sense when applied over periods when actual output and inflation are fairly stable. But they do not adjust fast enough when output or inflation vary significantly. This was the case, for example, during the late 1960s and much of the 1970s, when inflation took off in many OECD countries, strongly suggesting that average real short-term interest rates were in fact well below neutral. Similarly, univariate filters mistake a large portion of the disinflationary policy action of the late 1970s and early 1980s for an upward shift in the neutral rate.

— Kalman-filter estimates of the US neutral real short-term interest rate —



Source: Update of Laubach and Williams (2003), see footnote 2 in this box.

1. See Neiss, K. and E. Nelson, “The real interest rate gap as an inflation indicator”, *Macroeconomic Dynamics*, Vol. 7, No. 2, 2003.

terruptedly since 2000, although not by much on average.¹⁹ Yet, against the background of substantial residual slack in the economy, both headline and core inflation should ease over the next two years, suggesting that over the next few quarters, a wait-and-see posture may remain appropriate.

19. The Eurosystem focuses on medium-run inflation developments rather than on transient ups and downs, and since the launch of the euro annual headline inflation for the harmonised index of consumer prices has averaged exactly 2.0 per cent.

Box I.4. Where does the “neutral” interest rate lie? (cont.)

Multivariate estimates are more informative. Approaches designed to avoid this drawback therefore simultaneously take into account the interest rate, inflation and output. One such approach uses a technique called the Kalman filter to adjust the estimated neutral rate for deviations between predicted and actual GDP. For instance, if actual GDP exceeds predicted GDP, part of the unexpected strength in economic activity is attributed to a more stimulative monetary policy, and hence the estimate of the neutral rate is raised proportionately.² In the US case, the Kalman-filter methodology applied on four decades of data suggests that since the 1960s the neutral short-term interest rate has fluctuated between 2 and 5 per cent, and that in the third quarter of 2004 it stood at 2.1 per cent.

The neutral rate varies over time, across countries and across models. Studies on the euro area suggest that since the mid-1990s, the neutral rate has come down, to around 2¾ per cent by 2000 and to about 1½ to 2 per cent by the Spring of 2002.³ For Canada, the neutral rate has been estimated at 1¼ to 2 per cent in late 2002.⁴ For New Zealand, a comparison between 14 different models of the neutral rate shows that while in all cases it declined during the 1990s, the estimates as of early 2003 ranged from ¾ to 4¼ per cent.⁵ Lastly, Kalman-filter estimates for Poland put the neutral

rate at around 4 per cent in 2003, down somewhat from its average level in earlier years, but clearly above euro area levels.⁶

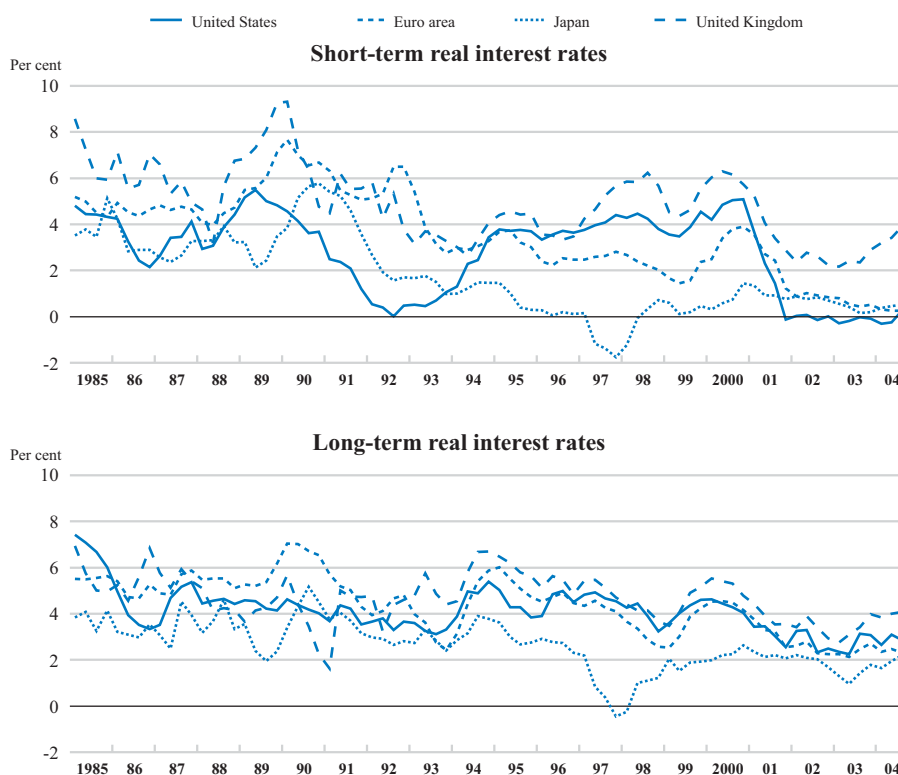
Lack of precision makes it difficult to make the neutral rate operational. The above examples illustrate that considerable uncertainty surrounds any estimate of the neutral rate. For policy purposes, this drawback is worsened by the fact that future data can substantially alter the estimate of today’s level of the neutral rate, as evidenced when comparing the estimate based on the full sample (two-sided filter), as above, with the one based on past data (one-sided filter), which makes use of observations only through the date at which the neutral rate is estimated.⁷ For example, based on past data only, the neutral rate in the United States was estimated to exceed 3 per cent until mid-2002. When taking into account the subsequent moderate recovery, notwithstanding a real funds rate of around zero, the most recent neutral rate estimate is reduced to just above 2 per cent, and the neutral rate estimate for 2001-02 is revised to about the same level. An additional, though less severe, problem is that the end-period data entering the estimation are at times subject to substantial revisions. Like other unobservable macroeconomic variables, the neutral rate, while informative, should be used with caution in policy making.⁸

2. For a more rigorous exposition, see Laubach, T. and J. Williams, “Measuring the natural rate of interest”, *Review of Economics and Statistics*, Vol. 85, No. 4, 2003. The real interest they use is an *ex ante* one, with inflation expectations proxied by a forecast of the four-quarter-ahead percentage change in the price index for personal consumption expenditures excluding food and energy, generated through a univariate autoregressive process.
3. See Giammarioli, N. and N. Valla, “The natural real rate of interest in the euro area”, *ECB Working Paper*, No. 233, 2003, which is based on a stochastic dynamic general equilibrium model and ends in 2000, and Crespo-Cuaresma, J., E. Gnan and D. Ritzberger-Gruenwald, “Searching for the natural rate of interest: a euro-area perspective”, *Empirica*, Vol. 31, No. 2-3, 2004, which is based on a multivariate unobserved component model and runs through the spring of 2002.
4. See Lam, J.-P. and G. Tkacz, “Estimating policy-neutral interest rates for Canada using a dynamic stochastic general-equilibrium framework”, *Bank of Canada Working Paper*, No. 2004-9, 2004.
5. See Basdevant, O., N. Björkstén and Ö. Karagedikli, “Estimating a time varying neutral real interest rate for New Zealand”, *Reserve Bank of New Zealand Discussion Papers*, No. 2004/01, 2004. The fact that the neutral rate seems to be higher in New Zealand than in the aforementioned OECD economies may reflect greater GDP and exchange rate volatility, lower liquidity of the debt denominated in New Zealand dollars and/or a high net foreign debt ratio.
6. See Brzoza-Brzezina, M., “The information content of the natural rate of interest: the case of Poland”, *mimeo*, 2004.
7. The one-sided estimate is not exclusively based on past information, as the model parameters are estimated using the entire sample. Nonetheless, given that these parameters are fairly stable over large parts of the sample, the one-sided estimate is a good approximation of what the neutral rate estimate would have been at that time, abstracting from later data revisions.
8. See Clark, T. and S. Kozicki, “Estimating equilibrium real interest rates in real time”, *Federal Reserve Bank of Kansas City Research Working Papers*, No. 04-08, 2004.

Monetary policy has also remained on hold for quite some time in Japan. The latest increase in the targeted level of bank current accounts at the Bank of Japan took place in January 2004. Interventions on the foreign exchange market, which were conducted on a massive scale until March 2004, have since ceased, and base money has decelerated strongly. At the same time, the process of contraction in bank lending, which started seven years ago, has continued, despite encouraging progress in reducing the stock of non-performing loans, through ongoing disposals and via a slowdown in the generation of new bad loans.²⁰ In the near term, with consumer price inflation still in negative territory, a continuation of the zero interest rate policy

... and in Japan

Figure I.13. Real interest rates remain relatively low



Note: Short-term refers to 3-month money market rates and long-term to 10-year government bond yields. Real interest rates have been deflated using the core inflation index (harmonised index for the euro area and the United Kingdom).
Source: OECD Economic Outlook 76 database.

is in order. While there is no evident need for further quantitative easing, the normalisation of interest rates should not start before inflation turns clearly positive.

Fiscal policy: speeding up consolidation

Fiscal adjustment should not be deferred any longer

Several OECD countries – including the United States, Canada, France and the United Kingdom – have enjoyed higher-than-projected revenue growth thus far in 2004. But at the same time, spending also continues to rise rapidly, in these as well as in a number of other OECD countries. More disquietingly, underlying fiscal positions generally are not improving and scant adjustment is in the pipeline (Table I.4) even though, as has been documented in earlier editions of the *OECD Economic Outlook*, fiscal positions are in many cases unsustainable. The momentous challenges lying ahead are admittedly acknowledged in virtually all OECD countries and are prompting a number of longer-run pension and health care reforms, but these need to gather pace (Box I.5).

20. Other signs of structural adjustment in the financial sector include the significant unwinding of cross-shareholdings amongst the big banks, which has halved since the late 1990s (see Nippon Life Insurance Research Institute, *Fiscal 2003 cross-shareholding survey*, September 2004). In addition, the Bank of Japan has recently announced that it would no longer purchase bank shares.

Table I.4. **Fiscal deficits are large and persistent**

	2002	2003	2004	2005	2006
	Per cent of GDP / Potential GDP				
United States					
Actual balance	-3.8	-4.6	-4.4	-4.1	-4.2
Cyclically-adjusted balance	-3.2	-4.1	-4.2	-4.0	-4.2
Cyclically-adjusted primary balance	-1.2	-2.3	-2.5	-2.1	-2.0
Japan ^a					
Actual balance	-7.9	-7.7	-6.5	-6.4	-6.3
Cyclically-adjusted balance	-6.8	-6.8	-6.3	-6.4	-6.6
Cyclically-adjusted primary balance	-5.4	-5.4	-4.8	-4.7	-4.5
Euro area					
Actual balance	-2.4	-2.8	-2.9	-2.6	-2.4
Cyclically-adjusted balance	-2.4	-2.0	-2.1	-1.8	-1.8
Cyclically-adjusted primary balance	0.9	1.0	0.8	1.1	1.1
OECD ^b					
Actual balance	-3.2	-3.7	-3.5	-3.2	-3.2
Cyclically-adjusted balance	-3.1	-3.4	-3.4	-3.3	-3.3
Cyclically-adjusted primary balance	-0.9	-1.4	-1.4	-1.2	-1.1

Note: Actual balances are in per cent of nominal GDP. Cyclically-adjusted balances are in per cent of potential GDP.

The primary cyclically-adjusted balance is the cyclically-adjusted balance less net debt interest payments.

a) Includes deferred tax payments on postal saving accounts amounting to 0.1 per cent of GDP in 2002.

b) Total OECD figures for the actual balance exclude Mexico and Turkey and those for the cyclically-adjusted balance further exclude the Czech Republic, Hungary, Korea, Luxembourg, Poland, the Slovak Republic and Switzerland.

Source: OECD Economic Outlook 76 database.

*Fiscal consolidation will
require new measures in the
United States...*

... as well as in Europe...

In the United States, tax receipts as a share of GDP essentially stopped falling this year, mainly thanks to buoyant corporate profits. With the end of the 2004 tax refunds, the expiration of accelerated depreciation allowances and the slowing of federal government purchases, the fiscal stance – as measured by the change in the primary cyclically-adjusted balance – is shifting from slightly expansionary to moderately restrictive. However, revenues are not set to improve endogenously as much as they did during the second half of the 1990s, in a context of buoyant financial market conditions and growth. At the same time, spending commitments – whether or not already explicitly built into budgets – are growing rapidly. Among the larger uncertainties are the fate of the sunset clauses associated with the tax cuts implemented in recent years and the extent to which the alternative minimum tax (AMT), which if left unchanged will affect a growing proportion of taxpayers, will be indexed or otherwise altered.²¹ On the spending side, formal budget plans assume restraint, but discretionary spending has tended to systematically overshoot programmed amounts. An additional uncertainty relates to the evolution of military spending.

In Europe, the 2004 headline general government deficit is set to approach or exceed 3 per cent of GDP in eleven of the 19 European Union (EU) countries that are OECD members. In the euro area, half of the countries are in this situation. Moreover, in some cases, the magnitude of the fiscal gap has been understated in the

21. The AMT is intended to limit taxpayers' ability to use certain tax breaks (it essentially boils down to adding back some of the latter into adjusted gross income). Estimates prepared by the Congressional Budget Office suggest that indexing the AMT for inflation would cost about ½ per cent of GDP each year.

Box I.5. Where do public pension reforms stand?

How sustainable are public pension systems? Over recent years, the progress across the OECD area in putting public pension systems on a sustainable basis has been mixed, with some countries still facing considerable increases in pension expenditure. Even after reforms, estimates point to spending increases of at least 2 per cent of GDP up to 2050 for half of the countries listed. An inability to address pension challenges in a timely manner risks increasing the scale of adjustment to benefit levels and contribution rates when they are eventually put in place. Moreover, long lead times are required to enable individuals to adapt their behaviour in response to alterations in pension system rules, so that actions to ensure the sustainability of public pensions have become increasingly urgent.

Ensuring pressure from ageing is minimised. Those countries where the projected increase in outlays is greatest (given current demographic projections) generally operate defined-benefit systems. Where defined-benefit public pension systems appear to be financially sustainable, a salient feature is that an earnings-related defined-benefit pension is not the only pension vehicle. In these cases, a share of retirement income will be derived from other pensions and also personal saving (for example, private pension saving is mandated in Australia and Hungary and encouraged in some other countries). With this type of pension system structure, the impact of ageing is a smaller threat to public finances in these countries. This is nonetheless contingent on the political sustainability of pensioner income declining relative to median income if insufficient supplementary pension income is available on retirement. An additional means of reducing pressure from ageing is through closing pathways to early retirement, as they can represent a considerable fiscal cost.

The notional defined-contribution pension is an alternative approach to achieving sustainability and a relatively recent innovation. This system determines benefit levels on the basis of contributions but uses a “revaluation factor” that mimics investment returns and allows for life expectancy at the point of retirement. The explicit consideration of life expectancy on retirement adds robustness to the public pension system by reducing pressure on public finances arising from increasing longevity. Linking the benefit level to life expectancy on retirement can allow individuals greater choice of retirement age, though this attribute is present in other types of pension systems which build in actuarially fair adjustments to benefit levels for early or later retirement. As

life expectancy increases, individuals may need to remain in employment longer to attain their targeted replacement rates.

Parametric reforms can gradually reduce fiscal costs. The countries with less sustainable defined-benefit pensions largely rely on pay-as-you-go systems. There, incremental change through reforms of parameters such as benefit levels or contribution rates has reduced the projected burden somewhat, though further reforms will be necessary in most cases. Some of the recent reforms have indexed benefits payments to prices or to total wage bill growth rather than to per capita wage growth so as to cap the ratio of pension costs to wages. A second element is scheduled rises in contribution rates over time, running the attendant risk of weighing on GDP growth.

Pre-financing and paying down debt can ease the burden. While pension-system reforms are essential for containing ageing pressures, reducing government net debt can also assist governments in meeting the challenges arising from ageing. For example, Canada is pre-funding its second tier pension in a separate off-budget account. While other countries have adopted policies that nominally finance pension liabilities (or reduce national debt), significant and often rapid deteriorations of fiscal positions, such as in Japan over the 1990s and in the United States more recently, highlight the vulnerability of this strategy, especially in the absence of forward-looking fiscal rules.¹

Governments need to consider the implicit liabilities associated with private pension provision. Ultimately reforms need to ensure that individuals on retirement will have adequate financial resources and, in this context, governments are increasingly looking to boosting private pension saving. If, however, pensioner income relative to median income falls to politically unacceptable levels, governments may be unable to resist pressure to guarantee income adequacy. A particular risk has arisen with respect to corporate pension plans, where large funding gaps emerged as tumbling stock prices eroded pension fund assets, highlighting the importance of ensuring adequate funding.² Government policy aimed at buttressing private pension provision needs to be carefully designed so as to avoid creating adverse incentives (such as pension fund insurance giving rise to underfunding) and imposing unnecessary regulatory burdens on private pension providers. A sound prudential framework is essential for encouraging effective private pension saving.

1. See “Fiscal sustainability: the contribution of fiscal rules”, *OECD Economic Outlook*, No. 72, 2002 for a review of fiscal rules being used in OECD countries.

2. See Box I.4 in *OECD Economic Outlook*, No. 74, 2003 for a discussion of funding gaps in corporate pensions.

Box I.5. Where do public pension reforms stand? (cont.)

Reforms of retirement income systems in selected OECD countries^a

	Date of last major reform	Gross replacement rate of mandatory pensions in 2003	National estimate of public pension spending increase Per cent of GDP 2000 to 2050	Public pension benefit	Mandatory private regime	Last major reforms		Actuarial adjustment (earliest possible age)
						Changed level of defined benefits	Increased contribution rates	Per cent per annum ^b
Poland ^c	1999	70	-8.1	Notional defined contribution	Yes	Abolished	No	6.3
United Kingdom	2003	48	0.2	Defined benefit	No	No	No	10.4
Italy ^d	2004	70	0.1	Notional defined contribution	No	Abolished	No	7.7
Japan ^e	2004	53	0.7	Defined benefit, nominally funded	No	Reduced	Yes	12.0
Sweden ^f	1998	76	1.5	Notional defined contribution	Quasi	Abolished	No	6.2
Australia	1992	52	1.6	Defined benefit	Yes	No	No	9.4
Luxembourg	2002	71	1.9	Defined benefit	No	Increased	Yes	
United States	1983	45	2.0	Defined benefit, nominally funded	No		No	5.8
Canada	1997	56	2.2	Defined benefit, prefunded	No	No	No	6.0
France ^g	2003	71	2.7	Defined benefit	No	Reduced	Yes	5.0
Belgium ^h	2000	60	3.1	Defined benefit, debt repayment	No	Reduced	No	0.0
Hungary ⁱ	1998	85	3.4	Defined benefit	Yes	Reduced	No	0.0
Germany	2001	46	4.1	Defined benefit	No	Reduced	Yes	6.0
Czech Republic	1995	45	4.7	Defined benefit	No	Reduced	No	6.0
Korea	1988	71	5	Defined benefit, nominally funded	No	No	No	5.0
Greece	1992	53	10.0	Defined benefit	No	Increased	Yes	0.0

a) The coverage of pension spending is less homogeneous across countries than over time.

b) The actuarial adjustment is a change in the benefit level to take account of the pension contributions made and life expectancy upon retirement.

c) Assumes 2 per cent growth in the revaluation factor. The drop in projected pension outlays reflects a major shift away from the pay-as-you-go pillar, but the current national estimate far exceeds earlier OECD estimates and may overstate the extent of the foreseeable decline.

d) For people retiring after 2010. In 2004, the Italian parliament passed a framework law allowing the government to introduce implementing legislation to reduce the fiscal burden of pensions, including reforms to encourage later retirement and to augment the main pension with a supplementary pension.

e) The end-point of the projection is 2025 instead of 2050.

f) Assumes a revaluation factor of 1.6 per cent.

g) The end-point of the projection is 2040 instead of 2050.

h) Regime for private sector employees. The end-point of the projection is 2030 instead of 2050.

i) Excluding pensions financed by the Health Insurance Fund.

Source: National submissions in the 2003-04 stability or convergence programmes for EU countries (except Greece); Canadian Office of the Superintendent of Financial Institutions; US Congressional Budget Office; Japanese Ministry of Finance; forthcoming OECD Survey of Greece; Korea Development Institute; OECD, *Sustainable Development in OECD Countries: Getting the Policies Right*, Paris, forthcoming.

headline budgetary statistics.²² The ongoing deterioration is especially striking in Greece. Against this backdrop of serious slippages, new tax reductions are to be implemented in 2005 in several countries, although in some the cuts are offset by spending measures or revenue-raising initiatives. It is important indeed that any cuts in tax rates be financed by base broadening and/or by spending measures, so that cyclically-adjusted deficits are put on a firm downward path in the coming years, with the pace of improvement necessary to enhance credibility probably being at least ½ percentage point of GDP per annum, in line with what has been an official objective for some time. In addition, any tax windfalls, such as witnessed in France during 2004, ought to be used primarily for deficit reduction. Efforts are also being deployed in a number of euro area countries, both *ex ante* and during budget execution, to restrain public spending, but overruns keep reoccurring, not least in areas such as health care. Fundamental reforms in a number of these areas are called for, rather than repeated stop-gap measures.

... where some of the rules are being rewritten

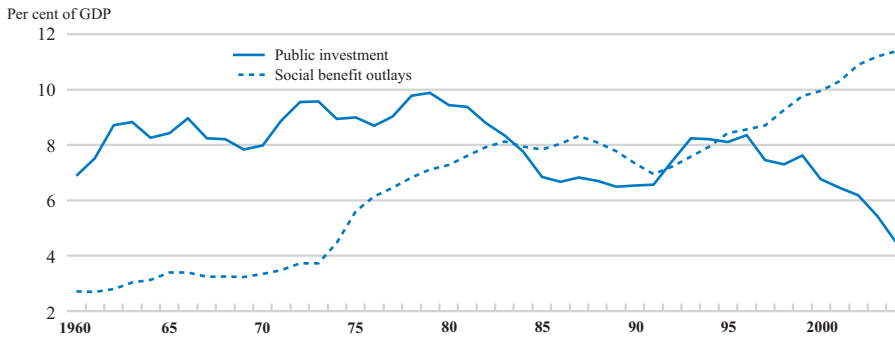
Sound and enforceable fiscal rules can contribute to fiscal discipline and help preserve or restore public finance sustainability, but they cannot substitute for such fundamental public spending reform. In Europe, the Stability and Growth Pact probably limited the deterioration in fiscal positions during the downturn, but it eventually proved far less binding than originally intended. An amended interpretation of the Pact has recently been proposed by the European Commission. It introduces extra flexibility by offering a looser definition of the “exceptional circumstances” under which the deficit can exceed 3 per cent of GDP without triggering disciplinary action. It also allows more leeway in deciding on the speed at which a deficit that is deemed excessive should be reduced, by explicitly taking into account the level of public debt and its dynamics. Furthermore, in line with earlier understandings, one-off measures are to be identified and controlled for more systematically. Finally, the intention is to strengthen incentives to exercise fiscal restraint during cyclical upturns. Overall, if not supported by binding mechanisms, continued reliance on peer pressure to enforce fiscal objectives would call for much greater self-discipline than mustered to date.

Fiscal efforts need to be more ambitious in Japan

In Japan, the general government deficit is projected to decline in calendar year 2004, to 6½ per cent of GDP, with gross public debt reaching 164 per cent of GDP. The effects of higher-than-projected growth and continued cuts in public investment (Figure I.14) are being partly offset by increased old-age-related spending, coupled with lower revenues due to reduced tax rates and reverse “bracket creep”, as deflation pushes taxpayers into lower brackets. For fiscal year 2005, reductions in public investment and non-priority discretionary spending are planned, alongside social security reform, so that virtually no increase in general-purpose spending would be allowed. Further out, pension contributions will continue to rise over the coming decade following the passage of the reform bill. But rising debt-servicing costs, as interest rates move towards normalisation and debt continues to accumulate, will work in the opposite direction. More ambitious efforts – possibly in the form of a higher value-added tax rate – will be needed for the government to reach its goal of a

22. Compared with the March 2004 notification to Eurostat, the Greek deficit for 2003 has been revised up by almost 3 percentage points, to 4.6 per cent of GDP, with large upward revisions for earlier years as well. At the same time, the 2003 public debt ratio has been revised up by 7½ percentage points, to 110 per cent of GDP. In several other European countries, various measures embellish the reported fiscal balance and/or debt without a commensurate improvement in underlying positions, see Koen, V. and P. van den Noord, “Fiscal gimmickry in Europe: One-off measures and creative accounting”, *OECD Economics Department Working Papers*, forthcoming.

— Figure I.14. **Public investment shrinks but social benefit outlays rise** —



Source: OECD Economic Outlook 76 database.

primary surplus by the early 2010s. Public-sector reform can also help, and in this regard the steps recently announced to overhaul and prepare Japan Post for privatisation are encouraging, although it will be important to ensure that in the process the entity's monopoly power and state-sponsored privileges be duly curtailed.

Appendix: Corporate sector exposure to a rise in interest rates

As the recovery matures, interest rates might be expected to revert to more neutral levels, although timing and pace are very likely to differ across countries. How various economies will be affected depends *inter alia* on the resilience of their respective corporate sectors to interest rate hikes, as well as the latter's magnitude. Where firms tend to have higher debt loads and/or more limited financial resources to meet growing interest-rate obligations, the corporate sector is more likely to experience stress as monetary policy is tightened. This risk can be assessed by examining corporate balance sheet information drawn from the Worldscope database for the United States, Japan, Germany and the United Kingdom (Table I.5).²³ In this context, both economy-wide average indebtedness indicators and their distribution across firms are relevant.

It may be particularly instructive to compare the current situation with 1993, as it was also a year preceding a major policy tightening cycle. Compared with a decade ago, average debt-to-equity ratios have declined in the United States and especially Japan, where they had reached unparalleled levels in the early 1990s. In contrast, debt/equity ratios have increased in Germany – even if the trend appears to have reversed since 2001 – and even more so in the United Kingdom, where they have increased sharply in recent years.²⁴

Turning to the distribution of debt loads across firms, the share of the US and of the UK corporate sector – whether based on equity-market capitalisation or employment – that is highly indebted and thus most exposed to an increase in interest rates, had declined significantly by 2003. By contrast, in Japan and Germany, the proportion of heavily leveraged firms had risen.

Table I.5. Debt-to-equity ratios

	<i>In per cent</i>							
	United States		Japan		Germany		United Kingdom	
	1993 ^b	2003	1993 ^b	2003 ^c	1993 ^b	2003 ^c	1993 ^b	2003
Mean debt/equity ratio ^a	112	83	200	109	95	131	69	101
Share of market capitalisation represented by firms with high debt/equity ratios ^d	24	19	26	36	18	38	40	30
Share of employment represented by firms with high debt/equity ratios ^d	25	16	21	31	23	27	29	13
<i>Memorandum item:</i>								
Aggregate debt/equity ratio ^e	53	49	188	139	125	154	37	39

^a) Debt/equity ratios for individual firms are weighted by their share in total market capitalisation and then aggregated to derive the economy-wide mean debt/equity ratio shown here.
^b) Data for 1993 include all non-financial firms listed on the stock exchange in 1993 (*i.e.* firms that were delisted since then and no longer in business are also included).
^c) For 215 Japanese and 68 German firms, 2003 data are not available and 2002 data have been used, but this should not significantly affect the results.
^d) High debt/equity ratios are those that are at least one standard deviation above the mean.
^e) From flow-of-funds statistics. For Germany debt as a percentage of gross value added is shown.
Source: Datastream and Deutsche Bundesbank.

23. Worldscope is maintained by Datastream and includes all major non-financial corporations listed on the stock exchanges of the said four countries, accounting for about a fifth of employment in the non-financial sector as a whole and a large fraction of market capitalisation.

24. The accounting perspective in the Worldscope database is conceptually different from the approach in the flow-of-funds statistics, where the market value rather than the book value of equity is used.

Vulnerability to interest rate increases also has to be gauged in the light of firms' ability to service their debt following the resultant shock to their cash flow (Table I.6). One relevant indicator is the ratio of current assets to current liabilities, or the "current ratio".²⁵ Another is the share of short-term in total debt: as interest rates back up, firms more dependent on short-term debt will face a quicker debt roll-over at the new, higher interest rates.²⁶ For the analysis here, firms are said to be in the "vulnerable zone" if their current ratio is under 1.5 when their debt/equity ratio exceeds 100 per cent or when their share of short-term debt exceeds 30 per cent.²⁷

Table I.6. Share of firms in the vulnerable zone

In 2003, in per cent

	Based on market capitalisation	Based on employment
United States		
Debt/equity ratio > 100 per cent	27	19
Share of short-term debt > 30 per cent	16	11
Japan		
Debt/equity ratio > 100 per cent	46	37
Share of short-term debt > 30 per cent	41	59
Germany		
Debt/equity ratio > 100 per cent	36	54
Share of short-term debt > 30 per cent	22	45
United Kingdom		
Debt/equity ratio > 100 per cent	40	29
Share of short-term debt > 30 per cent	30	13

Source: Datastream.

In 2003, a lower proportion of US firms combined high overall indebtedness or a high share of short-term debt with a low liquid asset coverage of short-term liabilities compared with their Japanese, German and UK counterparts. However, on current projections, US firms are likely to face larger increases in interest rates.

25. Current assets consist of cash and other assets that could reasonably be expected to be liquidated, sold or consumed within one year. Current liabilities represent debt or other obligations that a company expects to meet within one year.

26. It should be borne in mind, however, that a portion of long-term debt carries a variable interest rate.

27. The 100 per cent benchmark for the debt/equity ratio is chosen to facilitate cross-country comparisons. The results are similar if the respective 2003 country means are used. As to the current ratio, the business finance literature suggests a threshold of 1.5 to 2.0. The 30 per cent benchmark for the short-term debt share is between the means for US and UK firms, the means for Japan and Germany being closer to 50 per cent.

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Conventional signs

\$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mbd	Million barrels per day	Trillion	Thousand billion
..	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		

Summary of projections

	2004	2005	2006	2004		2005		2006		Fourth quarter			
				Q4	Q1	Q2	Q3	Q4	Q1	Q2	2004	2005	2006
Per cent													
Real GDP growth													
United States	4.4	3.3	3.6	3.5	3.1	3.2	3.4	3.5	3.6	3.7	3.8	3.3	3.6
Japan	4.0	2.1	2.3	2.8	2.3	2.5	2.5	2.5	2.2	2.1	2.6	2.4	2.1
Euro area	1.8	1.9	2.5	1.7	1.9	2.1	2.5	2.5	2.5	2.5	1.9	2.3	2.5
Total OECD	3.6	2.9	3.1	2.9	2.9	3.0	3.2	3.2	3.1	3.1	3.1	3.1	3.1
Inflation													
United States	2.0	1.8	1.7	1.5	2.1	1.7	1.7	1.7	1.9	1.6	2.2	1.8	1.7
Japan	-2.3	-1.3	-0.3	-1.6	-1.5	-1.2	-1.0	-0.6	0.0	0.1	-1.6	-1.1	0.2
Euro area	1.9	1.7	1.8	1.4	1.9	1.9	1.7	1.7	1.8	1.8	1.7	1.8	1.8
Total OECD	1.8	1.7	1.7	1.4	1.8	1.5	1.7	1.8	1.8	1.6	1.9	1.7	1.7
Unemployment rate													
United States	5.5	5.3	5.1	5.4	5.4	5.4	5.3	5.3	5.2	5.2	5.4	5.3	5.0
Japan	4.8	4.5	4.2	4.8	4.7	4.6	4.5	4.4	4.3	4.2	4.8	4.4	4.0
Euro area	8.8	8.6	8.3	8.8	8.7	8.7	8.6	8.6	8.4	8.4	8.8	8.6	8.2
Total OECD	6.6	6.5	6.3	6.5	6.5	6.5	6.5	6.4	6.4	6.3	6.5	6.4	6.2
World trade growth	9.5	9.0	9.5	8.4	8.7	8.9	9.3	9.4	9.7	9.7	9.4	9.1	9.6
Current account balance													
United States	-5.7	-6.2	-6.4										
Japan	3.5	3.5	3.7										
Euro area	0.7	0.6	0.9										
Total OECD	-1.2	-1.4	-1.3										
Cyclically-adjusted fiscal balance													
United States	-4.2	-4.0	-4.2										
Japan	-6.3	-6.4	-6.6										
Euro area	-2.1	-1.8	-1.8										
Total OECD	-3.4	-3.3	-3.3										
Short-term interest rate													
United States	1.5	2.8	3.8	2.1	2.5	2.7	3.0	3.2	3.5	3.7	2.1	3.2	4.2
Japan	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.0	0.0	0.5
Euro area	2.1	2.1	2.7	2.1	2.1	2.1	2.1	2.1	2.3	2.5	2.1	2.1	3.0

Note: Real GDP growth, inflation (measured by the increase in the GDP deflator) and world trade growth (the arithmetic average of world merchandise import and export volumes) are seasonally and working-day-adjusted annual rates. The "fourth quarter" columns are expressed in year-on-year growth rates where appropriate and in levels otherwise. The unemployment rate is in per cent of the labour force while the current account balance is in per cent of GDP. The cyclically-adjusted fiscal balance is in per cent of potential GDP. Interest rates are for the United States: 3-month eurodollar deposit; Japan: 3-month certificate of deposits; euro area: 3-month interbank rate.

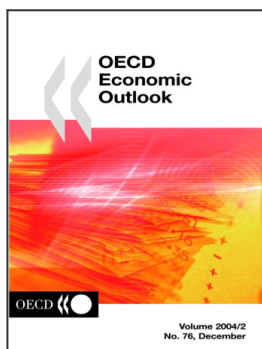
Assumptions underlying the projections include:

- no change in actual and announced fiscal policies;

- unchanged exchange rates as from 5 November 2004; in particular 1\$ = 105.70 yen and 0.771 euros;

The cut-off date for other information used in the compilation of the projections is 18 November 2004.

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